S. Hrg. 102-166

REAUTHORIZATION OF THE GOVERNMENT SECURITIES ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

S. 1247

TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO EXTEND THE REGULATORY AUTHORITY OF THE SECRETARY OF THE TREASURY UNDER THE GOVERNMENT SECURITIES ACT OF 1986, AND FOR OTHER PURPOSES.

JUNE 12, 1991

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
45-918 WASHINGTON : 1991

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-035452-8

5241-50.

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

DONALD W. RIEGLE, Jr., Michigan, *Chairman*

ALAN CRANSTON, California
PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
ALAN J. DIXON, Illinois
JIM SASSER, Tennessee
TERRY SANFORD, North Carolina
RICHARD C. SHELBY, Alabama
BOB GRAHAM, Florida
TIMOTHY E. WIRTH, Colorado
JOHN F. KERRY, Massachusetts
RICHARD H. BRYAN, Nevada

JAKE GARN, Utah
ALFONSE M. D'AMATO, New York
PHIL GRAMM, Texas
CHRISTOPHER S. BOND, Missouri
CONNIE MACK, Florida
WILLIAM V. ROTH, Jr., Delaware
PETE V. DOMENICI, New Mexico
NANCY LANDON KASSEBAUM, Kansas
JOHN H. CHAFEE, Rhode Island

Steven B. Harris, *Staff Director and Chief Counsel*
Lamar Smith, *Republican Staff Director and Economist*

Subcommittee on Securities

CHRISTOPHER J. DODD, Connecticut, *Chairman*

RICHARD C. SHELBY, Alabama
TIMOTHY E. WIRTH, Colorado
ALAN CRANSTON, California
JIM SASSER, Tennessee
TERRY SANFORD, North Carolina

PHIL GRAMM, Texas
WILLIAM V. ROTH, Jr., Delaware
ALFONSE M. D'AMATO, New York
CHRISTOPHER S. BOND, Missouri
CONNIE MACK, Florida

Martha L. Cochran, *Staff Director and Chief Counsel*
Michael J. Stein, *Financial Policy Analyst*
Bradley D. Belt, *Republican Counsel*
Ira Paull, *Republican Counsel*

CONTENTS

WEDNESDAY, JUNE 12, 1991

Page
Opening statement of Senator Dodd 1
  Proposed bill S. 1247 5
Opening statements of:
  Senator Gramm 15
  Senator D'Amato 15

WITNESSES

Richard C. Breeden, Chairman, Securities and Exchange Commission, Washington, DC 16
  Prepared statement 21
    I. Overview of the Government securities market 22
    II. Development of the Government Securities Act 27
    III. Summary of recommendations 28
    IV. Transparency in the Government securities market 32
    V. Rules governing sales practices 38
    VI. Expanding required SIPC coverage 46
    VII. Conclusion 49
John P. LaWare, Governor, Board of Governors of the Federal Reserve, Washington, DC 51
  Prepared statement 55
Robert Glauber, Under Secretary for Finance, U.S. Department of the Treasury, Washington, DC 63
  Prepared statement 67
    Developing rules to ensure fair and efficient markets 67
    Extension of Treasury's rulemaking authority 69
    Sales practice rules 70
    Access to Government securities price and volume information 74
    Technical and conforming amendments 77
    Conclusion 77
Robert V. Stout, finance director, Ridgefield, CT, on behalf of the Government Finance Officers Association 87
  Prepared statement 91
    Introduction 91
    The need for investor protection 91
    Investment policies and practices 92
    Sales practices 93
    The need for sales practice rules 97
    Rulemaking authority 98
    Enforcement authority 99
    Conclusion 100
Joseph R. Hardiman, president, National Association of Securities Dealers, Washington, DC 101
  Prepared statement 104
    I. The NASD 105
    II. Extension of Treasury rulemaking authority 106
    III. Sales practice authority and related issues 106
    IV. Availability of Government securities pricing information 110
    V. Treasury bill—S. 1247, "Government Securities Act Amendments of 1991" 111
    VI. Conclusion 113

Page
John Corzine, partner and co-head, Fixed Income Division, Goldman, Sachs & Co., New York, NY, on behalf of the Public Securities Association ... 114
  Prepared statement ... 123
    General comments ... 124
    Reauthorization of the Treasury ... 125
    Government securities pricing information ... 126
    Sales practice rules ... 127
    Extension of SIPC insurance ... 130
    Conclusion ... 130

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

The Secretary of the Treasury, July 9, 1991, comments on S. 1247 ... 140
Comments on S. 1247, from the Federal Reserve System, SEC, and FDIC, dated July 19, 1991 ... 141
GAO, July 22, 1991, views on S. 1247 ... 142
Department of the Treasury, June 6, 1991, draft bill on Government Securities Act Amendments of 1991 ... 147
Department of the Treasury, April 1, 1991, views on legislation ... 163
Federal Reserve System, March 6, 1991, views on legislation ... 166
SEC, February 26, 1991, comments on GAO proposals concerning regulation of Government securities market ... 169
SEC, response to request of Senators Dodd and Heinz concerning GAO recommendations for amending the Government Securities Act of 1986 ... 171
Comptroller of the Currency, April 1, 1991, comments on issues concerning Government Securities Act of 1986 ... 193
Federal Deposit Insurance Corporation, January 23, 1991, views of legislation . 197
Office of Thrift Supervision, February 20, 1991, views of legislation ... 201
Securities Investor Protection Corporation, February 7, 1991, comments on legislation ... 203
National Association of Securities Dealers, Inc., February 1, 1991, views on recommendations for legislation ... 207
U.S. Department of Housing and Urban Development, January 31, 1991, views on the implementation of the Government Securities Act of 1986 ... 215
Fannie Mae, January 24, 1991, comments on proposed legislation ... 217
New York Stock Exchange, January 18, 1991, comments on supplemental legislation ... 219
Government Finance Officers Association, March 7, 1991, position on issues related to legislation ... 221
Public Securities Association, January 22, 1991, views on legislation ... 228
American Bankers Association, January 25, 1991, views on legislation ... 236

REAUTHORIZATION OF THE GOVERNMENT SECURITIES ACT

WEDNESDAY, JUNE 12, 1991

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 2:06 p.m., in room SD–538 of the Dirksen Senate Office Building, Senator Christopher Dodd (chairman of the subcommittee) presiding.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. The subcommittee will come to order.

I'd like to welcome everyone here this afternoon on our hearing on S. 1247, the Government Securities Act Amendments of 1991.

Let me also welcome someone who will be here very shortly, the new ranking member of the Securities Subcommittee, Senator Phil Gramm of Texas.

Here he is, timing is perfect.

Senator GRAMM. You just called my name?

Senator DODD. Just called your name.

Hark, I hear the beating of angels' wings.

Senator Gramm and I had the pleasure of working closely together a few years ago when I chaired the Subcommittee on Consumer Affairs. Senator Gramm is now moving into the ranking chair on the Securities Subcommittee, and I'm pleased to have the opportunity to work with Phil again.

This is a very uncertain time for the American economy, and obviously what's crucially important is that investor confidence be at the highest possible levels.

And with the dramatic demands for capital around the globe, it's going to be even more important that investors have confidence and are willing to place their funds in the markets.

And I can think of no other Member of the Senate who has expressed himself more clearly and directly on the issue of protecting shareholder rights and being steadfast in his commitment to those shareholders.

So I look forward to a close working relationship with Senator Gramm in the remainder of this Congress, as we deal with this issue and a variety of others that will come before us.

I'm pleased to work again with you.

Senator GRAMM. Thank you, Mr. Chairman.

Senator DODD. Let me turn briefly to the legislation before us.

It was proposed, as I think all of you in this room are aware, by the Department of the Treasury.

And Senator Gramm and I introduced the legislation at the request of the Department last week.

Very briefly, the bill reauthorizes Treasury's existing authority to write rules for Government securities brokers and dealers.

It grants new authority for Treasury to write sales practice rules for Government securities brokers and dealers.

It gives the NASD the authority to write Government securities sales practice rules for its members, subject to SEC approval.

NASD rules must be consistent with Treasury rules.

And last, it gives Treasury new authority to write rules to require disclosure of price and volume information for Government securities.

There are those who view this legislation as complicated and technical. They believe it is a bill that, to a great extent, regulates the large banks and large securities firms and has very little relevance to the vast majority of the American public.

I would point out to those who have raised that point that every single taxpayer in this country is affected by this legislation and the issues that we'll be discussing this afternoon.

It's absolutely essential, in my view, that we maintain the liquidity and efficiency of the market for Treasury bonds, notes, and bills, so that Government funds are raised at the least possible cost to the American taxpayer.

Interest on the national debt, as we all know, is already the fourth largest item in the Federal budget.

Our primary goal in this legislation then must be to ensure that the Government securities market is as efficient as possible.

Let me add that an efficient market also has to be a fair market.

Fairness and efficiency are not opposite goals.

Investors have to believe that they will be treated fairly, or this market will lose the broad support necessary to make it liquid and efficient.

A fair market also is important also because cities and States around this Nation use the Government securities market as a place to invest State and local funds. We want to prevent failures or fraud in this market so that State and local taxpayers will not ultimately have to foot the bill.

Finally, the Government Securities Act covers not only Treasury securities, but mortgage-backed and agency securities as well. And certainly, American homeowners have a stake in the fairness of this market.

Fairness and efficiency, then, should be our goals, and our job today is to determine just how the Treasury proposal meets those goals or tries to meet those goals.

I'd like to just make a comment or two, if I could, about the process.

This committee is up against a very severe deadline.

Treasury's authority on this particular legislation expires October 1, 1991.

I calculate that to be about 40 legislative days, and I may be excessive in that estimation, but let's say 40 legislative days from this day.

The Securities Subcommittee wrote to the Secretary of the Treasury and to other agencies on December 10, 1990, requesting that legislative recommendations be submitted to us by the end of January of this year.

Virtually every other agency and private sector group sent their responses in earlier this year.

Treasury sent a letter to us on April 1 assuring us that the legislative language would be submitted soon.

After waiting almost 2 months, I wrote the Secretary again saying that I was prepared to move without Treasury's proposal, and had to schedule this hearing.

We received the bill only last week.

My concern at this point is that we have a major, "must do" banking bill coming up very, very soon which will dominate this committee's activities for a number of weeks.

And it may be impossible to move Government securities legislation before that measure.

And that is my concern.

On a second point, I would observe that this committee has slogged through too many turf wars in the past year or so.

I happen to be personally tired of that nonsense, and I'm confident that my ranking minority member feels likewise.

And despite my urging the Treasury for many months to get the agreement of other financial regulators before sending the bill up, we now find that that just hasn't happened.

The Federal Reserve which has the chief responsibility for marketing Treasury's debt, and has major oversight responsibility for the primary dealers, has strong reservations about this bill. The SEC is not totally on board, either.

So this subcommittee has its work cut out for it.

Finally, with respect to the legislation, itself, I read the bill as well as the section by section analysis submitted by Treasury, and the bill gives Treasury sweeping authority in the area of sales practice rules and access to pricing information.

But the authority is all discretionary.

Treasury may or may not act as it chooses. There are no real guidelines or standards on which Treasury must base its actions.

And up to this point, there's been very little or no discussion of how Treasury intends to proceed and be sensitive to the concerns voiced by investors in Government securities on the one hand, and market participants, on the other.

Treasury has one of the toughest and most critically important roles in the city and in our economy.

The Department clearly is overburdened with its massive responsibilities, ranging from the banking crisis to international financial policy.

Frankly, I've been a supporter of maintaining Treasury's rulemaking authority over this market, and I have indicated that I would be willing to consider giving the Treasury new authority, provided a case can be made.

I believe Treasury has done a good job,and at this point, I need to be convinced and assured, at least as one member here, that Treasury has, if nothing else, the time to give the issue the attention it deserves, as well as the sensitivity to write new rules in areas that will shape the efficiency and fairness of this market for years to come.

At any rate, we'll have some additional questions once our witnesses have had an opportunity to testify.

But let me turn to my colleague from Texas for any opening comments he may wish to make.

[Copy of proposed bill S. 1247 follows:]

II

102D CONGRESS
1ST SESSION

S. 1247

To amend the Securities Exchange Act of 1934 to extend the regulatory authority of the Secretary of the Treasury under the Government Securities Act of 1986, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JUNE 6 (legislative day, JUNE 3), 1991

Mr. DODD (for himself and Mr. GRAMM) (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Securities Exchange Act of 1934 to extend the regulatory authority of the Secretary of the Treasury under the Government Securities Act of 1986, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Government Securities Act Amendments of 1991".

SEC. 2. GOVERNMENT SECURITIES REGULATORY AUTHORITY.

(a) EXTENSION OF RULEMAKING AUTHORITY.—Section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o–5) is amended by repealing subsection (g).

(b) ADDITIONAL RULEMAKING AUTHORITY.—Section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o–5) is amended in subsection (b), by redesignating paragraphs (3), (4), (5), and (6) as paragraphs (5), (6), (7), and (8) and inserting after paragraph (2) the following new paragraphs:

"(3) The Secretary may propose and adopt rules—

"(A) which define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative with respect to transactions in Government securities effected by Government securities brokers and Government securities dealers; and

"(B) designed to promote just and equitable principles of trade with respect to transactions in Government securities effected by Government securities brokers or Government securities dealers that are financial institutions.

"(4) In furtherance of the objective of assuring adequate dissemination of Government securities price and volume information:

"(A)(i) The Secretary may propose and adopt rules and regulations designed to:

"(I) assure the prompt, accurate, reliable, and fair reporting, collection, processing, distribution, and publication of information with respect to quotations for and transactions in Government securities and the fairness and usefulness of the form and content of such information;

"(II) assure that all Government securities information processors may, for purposes of distribution and publication, obtain on fair and reasonable terms such information with respect to quotations for and transactions in Government securities as is reported, collected, processed, or prepared for distribution or publication by any processor of such information (including self-regulatory organizations) acting in an exclusive capacity; and

"(III) assure that all Government securities brokers, Government securities dealers, Government securities information processors, and, subject to such limitations as the Secretary, by rule, may impose as necessary or appropriate for the protection of investors or maintenance of fair and orderly markets, all other persons may obtain on terms which are not unreasonably discriminatory such information with respect to quotations for and transactions in Government securities as is published or distributed.

"(ii) No self-regulatory organization, Government securities information processor, Government securities broker, or Government securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to report, collect, process, distribute, publish, or prepare for distribution or publication any information with respect to quotations for or transactions in any Government security, to assist, participate in, or coordinate the distribution or publication of such information, or to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any Government security in contravention of any rules or regulations promulgated under this paragraph.

"(B) The Secretary may, by rule, as the Secretary deems necessary or appropriate in the public interest or for the protection of investors, after due consideration of any effects on the liquidity or efficiency of the Government securities market, require any Government securities broker or Government securities dealer who has induced, attempted to induce, or effected the purchase or sale of any Government security by use of the mails or any means or instrumentality of interstate commerce to report purchases, sales or quotations for any Government security to a Government securities information processor, national securities exchange, or registered securities association and require such a processor, exchange, or association to make appropriate distribution and publication of information with respect to such purchases, sales or quotations.".

(c) TECHNICAL AMENDMENT.—Section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o–5) is amended in subsection (d) by revising paragraph (2) to read as follows:

"(2) Information received by any appropriate regulatory agency, any Federal Reserve Bank, or the Secretary from or with respect to any Government securities broker or Government securities dealer or with respect to any person associated therewith may be made available by the Secretary, the recipient agency or the Federal Reserve Bank to the Commission, the Secretary, any appropriate regulatory agency, any self-regulatory organization, or any Federal Reserve Bank.".

SEC. 3. RULES BY REGISTERED SECURITIES ASSOCIATIONS.

Section 15A(f)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–3(f)(2)) is amended—

(1) in clause (E), by striking the word "and" at the end thereof;

(2) in clause (F), by striking the period at the end thereof and inserting instead ", and"; and

(3) by adding at the end thereof the following new clause: "(G) with respect to transactions in Government securities, to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade, provided such rules are consistent with any rule adopted by the Secretary of the Treasury pursuant to section 15C(b)(3)(A) of this title.".

SEC. 4. OVERSIGHT OF REGISTERED SECURITIES ASSOCIATIONS.

Section 19 of the Securities Exchange Act of 1934 (15 U.S.C. 78s) is amended—

(1) in subsection (b), by adding at the end thereof the following new paragraph:

"(5) The Commission shall consult with and consider the views of the Secretary of the Treasury (Secretary) prior to approving a proposed rule change filed by a registered securities association pursuant to section 15A(f)(2)(G) of this title, except where the Commission determines that an emergency exists requiring expeditious or summary action and publishes its reasons therefore. If the Secretary comments in writing to the Commission on such proposed rule change that has been published for comment, the Commission shall respond in writing to such written comment before approving the proposed rule change.".

(2) in subsection (c), by adding at the end thereof the following new paragraph:

"(5) With respect to rules adopted pursuant to section 15A(f)(2)(G) of this title, the Commission shall consult with and consider the views of the Secretary before abrogating, adding to, and deleting from such rules, except where the Commission determines that an emergency exists requiring expeditious or summary action and publishes its reasons therefor.".

SEC. 5 AMENDMENTS TO DEFINITIONS.

Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended—

(1) in paragraph 34(G) (relating to the definition of appropriate regulatory agency), by amending clauses (ii), (iii), and (iv) to read as follows:

"(ii) the Board of Governors of the Federal Reserve System, in the case of a

State member bank of the Federal Reserve System, a foreign bank, an uninsured State branch or State agency of a foreign bank, a commercial lending company owned or controlled by a foreign bank (as such terms are used in the International Banking Act of 1978), or a corporation organized or having an agreement with the Board of Governors of the Federal Reserve System pursuant to section 25 or section 25(a) of the Federal Reserve Act;

"(iii) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System or a Federal savings bank) or an insured State branch of a foreign bank (as such terms are used in the International Banking Act of 1978);

"(iv) the Director of the Office of Thrift Supervision, in the case of a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act) the deposits of which are insured by the Federal Deposit Insurance Corporation;";

(2) by amending paragraph (46) (relating to the definition of financial institution) to read as follows:

"(46) The term 'financial institution' means—

"(A) a bank (as defined in paragraph (6) of this subsection);

"(B) a foreign bank (as such term is used in the International Banking Act of 1978); and

"(C) a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act) the deposits of which are insured by the Federal Deposit Insurance Corporation."; and

(3) by adding at the end thereof the following new paragraph (relating to the definition of Government securities information processor):

"(53) The term 'Government securities information processor' means any person engaged in the business of (i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any Government security; or (ii) distributing or publishing (whether by means of a ticker tape, a communications network, a terminal display device, or otherwise) on a current and continuing basis, information with respect to such transactions or quotations. The term 'Government securities information processor' does not include any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation, any self-regulatory organization, any bank, Government securities broker, Government securities dealer, or savings association (as defined in section 3(b) of the Federal Deposit Insurance Act), if such bank, Government securities broker, Government securities dealer, or association would be deemed to be a Government securities information processor solely by reason of functions performed by such institutions as part of customary banking, brokerage, dealing, or association activities, or any common carrier, as defined in section 3(h) of the Communications Act of 1934, subject to the jurisdiction of the Federal Communications Commission or a State commission, as defined in section 3(t) of that Act, unless the Commission determines that such carrier is engaged in the business of collecting, processing, or preparing for distribution or publication, information with respect to transactions in or quotations for any Government security.".

O

OPENING STATEMENT OF SENATOR GRAMM

Senator **Gramm**. Well, Mr. Chairman, let me first say that I am happy to have the opportunity to serve with you and to be ranking member of this committee.

I think I look forward to it for several reasons.

One, you, Mr. Chairman, are an old and dear friend of mine, and we've worked together on many issues.

Second, I don't see this as a committee with jurisdiction of an area that has any real partisan overtones. If there's any partisanship to the issues we address, I haven't been smart enough to figure it out.

Maybe others have.

Finally, I think it's a very important area.

We have dominated the world's financial markets for a long time.

I think there's no guarantee that we're going to maintain that important position of dominance.

I think it's very important that we go back and look at our financial markets.

A lot of the regulations are very old, from another era.

And I think it's an area where we need to do a thorough review of how we regulate our markets and how they work.

I think there are real questions about how far we should be going in terms of being sure that we, for example, in the New York Stock Exchange, have the ability to sell foreign securities when the exchange is willing to come in and to basically make an assessment as to the company's bookkeeping, even though they may or may not use our standards of bookkeeping.

I think there are a lot of issues that need to be looked at, but I think our objective is basically the same, and that is, how do we make American markets more competitive, more efficient, safer.

And in my view, that is something that clearly is subject to debate, Mr. Chairman, and I think the decision will be made based on the strength of the arguments, not based on any preconceived notions people have about these issues or how they're going to fall in terms of partisanship.

I think basically these are issues that most people on main street America figure that it's our business to know about them, and they don't have to worry about them.

And people are not going to vote based on these issues, so I guess you might say that if politicians aren't going to catch heck, no matter what they do, or if they are going to catch heck, no matter what they will do, they will almost always do the right thing.

And so I'm counting on us to do it.

Senator **Dodd**. Very good.

Senator D'Amato?

OPENING STATEMENT OF SENATOR D'AMATO

Senator **D'Amato**. Mr. Chairman, you're to be congratulated for calling these hearings.

This is not an issue that's going to get the American public aroused, as Senator Gramm indicated, but it's something that I think we should get together on.

Since Congress passed the Government Securities Act in 1986, Treasury debt outstanding has grown from $1.6 trillion to almost $2.3 trillion, and in all the Government agency securities and today the Government securities market is bursting at the britches with almost $4 trillion of IOU's.

So instead of expanding the American Securities Act, Congress would do better and the American taxpayer would be much better off if we shrunk the Federal debt.

It's much easier to swallow new legislation than it is to put Uncle Sam on a diet.

While the Treasury and the SEC seem to agree on the need for sales practice rules and authority to promote better price dissemination, they cannot agree on who should write the rules.

As we proved with Operation Desert Storm, some turf is worth fighting for, but we don't need any regulatory turf wars at home.

Congress should not have to pick between Nick and Dick. [Laughter.]

Senator Dodd. Who wrote this statement? [Laughter.]

Senator D'Amato. Some things don't even need to be restated.

But that's what we're involved in. And it's sad.

We need a cease-fire, and we need it now. We need a permanent peace.

In the battle between the Treasury and the SEC, the only casualty is the American people.

Thank you, Mr. Chairman.

Senator Dodd. Very good.

Actually, Al, I made the same comment, that we're not going to have turf wars.

Well, we have a very distinguished panel of witnesses.

The Honorable Richard Breeden, who all of us know, is the Chairman of the Securities and Exchange Commission.

The Honorable John P. LaWare is Governor of the Board of Governors of the Federal Reserve.

And Bob Glauber is the Under Secretary for Finance at the Treasury Department.

We appreciate all three of you being with us today, and Richard, we'll begin with you in the order I've introduced you.

I'll ask you to try and keep your remarks down to around 7 or 8 minutes, if you would, please.

It would help us to move to the questions.

And I would just state at the outset that all prepared statements, supporting documents, evidence, whatever else you'd care to file along with your comments, will be included as part of the record without any objection from anyone here on the committee.

OPENING STATEMENT OF RICHARD C. BREEDEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. Breeden. Thank you, Mr. Chairman.

Senator Gramm, Senator D'Amato, it's our pleasure to be here to have a chance to discuss this most important topic.

The Government securities market is important to all of us as Federal taxpayers, since a small increase in the interest rate paid by the Federal Government means an immense increase in the cost to the Federal debt.

The Government securities market is also important to many of us as investors. There are millions of individuals who directly own Government securities. About one-third of outstanding Government securities, including savings bonds, are held by individuals, directly or through mutual funds.

Thus, what has traditionally been seen as a largely institutional market is increasingly also an important market for individual investors.

When we refer to the Government securities market, it's important to understand that this market includes securities issued or guaranteed not just by the Treasury Department in the form of bonds, bills and notes, but also securities issued or guaranteed by many other Federal agencies or Government-sponsored entities.

These include Freddie Mac, Fannie Mae, Ginnie Mae, the Farm Credit System, and the Federal Home Loan Bank System.

These entities issue not only debt and mortgage-backed securities, but also included within the broad category of exempt securities is the common stock of Freddie Mac and Fannie Mae, as well as many many specialized mortgage-backed securities including strips and residuals.

And all told, these five entities have almost $1.4 trillion in securities outstanding and trading in this market. So that when we talk about the market for Government securities, we're most clearly talking about a very large and very important market for Treasury securities, but we are also talking about an enormous market of securities of many other different types and characteristics.

The Treasury Department's authority to issue new rules under the Government Securities Act expires on October 1, 1991.

The Treasury has done a most capable job in implementing rules concerning capital, financial reporting and recordkeeping under the act, and the SEC supports renewal of the Treasury's rulemaking authority.

Beyond the obvious step of renewing the Treasury's current authority, Congress faces three major additional issues regarding potential revisions to the Government Securities Act.

These are: First, whether any Federal agency needs to be empowered to prescribe rules for the electronic dissemination of trade and quotation information and, if so, whether that authority should be immediately applicable or only applicable if current private efforts prove a failure.

Two, whether any Federal agency needs to be empowered to promulgate new rules governing sales practices of intermediaries in dealing with their customers relating to currently exempt securities. And, obviously, if any agency needs to do so, which agency it should be.

Three, whether SIPC insurance should be broadened, and if so, under what conditions.

The general themes of our testimony that we've submitted to the committee, and from my oral statement here today, are: If it isn't broken, let's not try and fix it. And to the degree that we must act in this market, I think, given its extraordinary record of successful operation as a market without extensive Government regulation, that least in this area is probably best.

The Government securities market appears to be working very well. Therefore, in revising the Government Securities Act, we should look for modest solutions building on existing rules and systems to those few existing problems that have been identified in the market, as well as to the potential problems that we should act to forestall.

On the issue of transparency, the progress of the PSA's GOVPX system to disseminate trade and quotation information for Treasury securities has been quite significant.

As the committee knows, that system is scheduled to begin operation next week.

It is designed to provide a great deal of valuable market information on a real time basis.

GOVPX represents a very large step forward, assuming of course that it works.

PSA should be congratulated for its efforts. We would question whether the great efforts of market participants need to be rewarded with Federal regulation before the system has even had a chance to operate.

In that respect, I think the view of the Commission is quite similar to that of the Federal Reserve in its testimony, in that we're very concerned whether the introduction at this preliminary stage, as this new system is coming in, of Federal rulemaking might in fact delay, rather than speed up, the completion of a reporting system.

Of course, there are still a few gaps in the system, notably that it does not include historical information valuable to buyers and that it covers only Treasury securities and not mortgage-backed and other forms of Government securities.

It also does not include best offer data, though it can and should do so.

We would hope that most gaps in the system could be filled in the reasonably near future as the system becomes operational and market participants gain actual experience with it.

We therefore do not see any need to give any agency general immediate authority to require transaction and quotation reporting in the Government securities market.

Rather, we favor creating limited backstop authority so that if, for some reason, GOVPX does not meet goals set by Congress, then regulatory action could be triggered that would require the market participants to create an appropriate reporting system.

This would allow the private sector's momentum to continue without interference, yet avoid the need to come back to Congress if current efforts falter.

The Commission already exercises responsibility for overseeing trading and reporting systems like GOVPX.

We have responsibilities today for the Intermarket Trading System, or ITS, NASDAQ, the Consolidated Tape, Instanet, POSIT, the Options Price Reporting System, PORTAL, the proposed FIP system of the NASD for junk bonds, Delta Government Options, and many, many other proprietary systems.

The Commission also has authority concerning trading in municipal bonds, another nearly trillion dollar market.

Therefore the Commission has by far the greatest capability in terms of staff, experience, and expertise, to monitor and oversee development of an electronic trade reporting system in the Government securities area.

With respect to sales practice issues, there do not yet appear to have been substantial sales practice abuses in the Government securities market.

It's important to note that sales practice rules do already exist.

The New York Stock Exchange has rules that apply to the Government securities activities of its members.

The NASD already has rules governing markups, churning, suitability, and unauthorized trading in every other type of security, but it is currently forbidden by law to apply these existing standards to violative conduct by its members.

Thus, what are supposed to be the safest securities are the only instruments where a customer of an NASD member is unprotected for sales practices abuses normally covered by NASD rules.

The Commission favors eliminating this loophole in the coverage of NASD rules so that these established industry rules can apply to the Government securities activities of the almost 1,500 NASD members who have Government securities businesses.

In considering the best possible system for sales practice oversight, it is important to remember the principles of functional regulation.

Sales practices are exactly that, a set of issues that relate to the behavior of a broker dealer.

Did he or she recommend a highly risky instrument to a customer unable to understand or bear the risks?

Did he or she make unauthorized trades for an account?

Did he or she make a cold call without proper customer warnings?

Did he or she charge an excessive markup as a dealer?

Did he or she engage in an unacceptably large number of transactions for the purpose of generating commissions?

The standards for these issues should not differ from the standards for sale of corporate or municipal securities.

If a single registered rep talks to a customer concerning purchases of an AT&T debenture, a State of Connecticut or Texas bond, or a principal strip of a pool of Freddie Mac and Fannie Mae instruments, indeed, even of a Treasury bill, the entire conversation between a single registered rep and a single customer ought to occur under a single set of standards.

Now we can make it more complex.

We can introduce 2, 3, 4, or 10 Government agencies to write different sets of standards so that, as the customer says, "well, what about this security?" a new set of rule books has to come off the shelf and be consulted, rather than a simple and understandable set of sales practice rules that every broker is under, and every broker and customer can hope to understand.

It is the simple system which we would prefer.

Finally, as to SIPC membership, the Commission has no position on whether Congress should extend SIPC coverage to the specialized Government securities brokers and dealers.

If SIPC coverage is extended, the Commission believes that all covered companies should be subject to the same rules.

Thus, if Congress requires SIPC coverage for specialized Government securities firms, Congress should also allow the NASD to issue and enforce rules, particularly financial responsibility rules and testing requirements for transactions in Government securities.

And, Mr. Chairman, if I can just say in conclusion—I'm sorry Senator D'Amato isn't here, but I find it unfortunate that at this early stage in which the agencies are really trying to give Congress our best input, that we would have totally absurd characterizations of battles between the Treasury and the SEC, which I don't think is an appropriate characterization of the conditions that exist.

We're here to try and give you the benefit of our views, and if Congress really doesn't want the views, then, fine, we can all do other things.

But I think the suggestions that our views constitute a turf battle here are premature, to say the least.

Thank you.

[Written statement of Richard C. Breeden follows:].

MCMXXXIV

TESTIMONY OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES & EXCHANGE COMMISSION

CONCERNING POSSIBLE AMENDMENTS OF THE GOVERNMENT SECURITIES ACT OF 1986

BEFORE THE SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

JUNE 12, 1991

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF
RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING POSSIBLE AMENDMENTS TO THE GOVERNMENT SECURITIES ACT OF 1986

BEFORE THE SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

JUNE 12, 1991

Chairman Dodd and Members of the Subcommittee:

I appreciate the opportunity to appear before this Subcommittee, on behalf of the Securities and Exchange Commission ("Commission"), to discuss possible amendments to the Government Securities Act of 1986 ("Government Securities Act").

I. OVERVIEW OF THE GOVERNMENT SECURITIES MARKET

The U.S. government securities market is one of the largest and most liquid securities markets in the world. As of the fourth quarter of 1990, there were approximately $3.98 trillion of government securities outstanding, including securities issued by the Secretary of the Treasury ("Treasury") and by numerous federal agencies and government-sponsored enterprises. [1]

Perhaps the most important point to note with respect to the U.S. government securities market is that securities issued by the U.S. Treasury are only some of the instruments that comprise this large and quite varied market. Thus, in addition to Treasury bills, notes, bonds, and strippable bonds, there are a number of other government agencies and government-sponsored enterprises that have issued and guaranteed government securities. For example, as of the end of 1990:

---

[1] 77 Fed. Reserve Bull. A43 (May, 1991) (Table 1.59).

- the Farm Credit System had about $55 billion in outstanding
    - notes and
    - bonds;
- the Federal Home Loan Bank System had about $118 billion in outstanding
    - notes and
    - bonds;
- the Federal Home Loan Mortgage Corporation ("FHLMC") had about $310 billion outstanding in mortgage-backed securities, and $36 billion outstanding in other securities, including
    - common stock [2]
    - long-term debt
    - mortgage-backed participation certificates, such as
        - regular participation certificates and
        - guarantor participation certificates, and
    - collateralized mortgage obligations, which consist of several tranches that have different maturities and risks;
- the Federal National Mortgage Association ("FNMA") had about $304 billion in mortgage-backed securities and $123 billion of other securities outstanding, including

---

[2] FHLMC's 60 million shares of common stock were worth $4.9 billion as of June 10, 1991.

- common stock [3]
- debentures,
- notes,
- guaranteed mortgage pass-through certificates, including stripped mortgage-backed securities --
  - interest-only certificates and
  - principal-only certificates;
- the Government National Mortgage Association ("GNMA") had about $404 billion in outstanding mortgage pools, primarily in its two main programs to guarantee privately issued securities backed by pools of mortgages--
  - GNMA I and
  - GNMA II. [4]

In addition to these instruments, securities that are components of government securities also trade. The simplest example is a stripped, zero-coupon Treasury security. More complex types have been developed, particularly in connection with mortgage-backed securities. The FNMA and the FHLMC have each issued securities based on pools of mortgages where either the cash flows have been stripped into the interest or principal components, or the cash flows from the mortgages have been otherwise divided among various interests in the pool.

---

[3] FNMA's 273 million shares of common stock were worth $13.2 billion as of June 10, 1991.

[4] See Kavros, First Boston's Guide to the Fixed Income Securities Market, 1989; 77 Fed. Reserve Bull. A32, A37 (May 1991) (Tables 1.44 and 1.54).

Private issuers have also used FNMA, FHLMC, and GNMA securities as a basis for creating numerous different "customized" securities based on, but not classified as, government securities. Many of these instruments involve highly sophisticated allocations of prepayment and other risks and have characteristics (e.g., lack of any return until maturity) that are sharply different from the characteristics of an ordinary Treasury security. In addition, derivative products based on government securities are traded on options exchanges and futures exchanges and in the over-the-counter market ("OTC"). These derivative instruments permit both dealers and investors in government securities to hedge and speculate on price movements in the underlying government securities.

There are numerous and varied intermediaries in this market. As of March 31, 1991, there were sixty-four registered broker-dealers trading government securities only, and 1,452 registered broker-dealers trading government securities in addition to conducting other types of securities business.[5] As of the same date, there were also 240 financial institutions that had notified their regulatory agencies that they were acting as government securities dealers.[6] The current federal regulatory oversight of these firms is allocated as follows:

---

[5] These figures are based on broker-dealer registration applications required to be filed with the Commission on Form BD.

Treasury	SEC	FRB	OCC	FDIC
64	1452	48	148	44

At the present time there are forty primary dealers, which are broker-dealers and banks authorized to trade government securities directly with the Federal Reserve Bank of New York in its execution of open market operations to regulate the money supply.[7] In January 1991, the average daily trading volume in Treasury securities among the primary dealers alone was approximately $127.3 billion. The comparable average daily figure for trading in securities issued by federal agencies and federally-sponsored agencies was approximately $6.2 billion and for mortgage-backed securities was approximately $12 billion.[8]

The government securities market has remained a primarily wholesale and institutional market, but with significant participation by individual investors. As of the third quarter of 1990, the latest period for which complete figures are available, households, including individual investors, held approximately 28% of outstanding government securities, including U.S. Savings Bonds.[9] As of the same date, Federal Reserve Banks held 6%; commercial banks, 12%; mutual funds, 5%; insurance companies, 7%; state and local governments, 11%; foreign and international investors, 12%; and other investors (such as savings and loan associations, credit unions, mutual savings banks, corporations, corporate pension trust funds, brokers and dealers, and federally-sponsored agencies), 19%.

---

[6] These figures are based on information supplied to the Commission on a quarterly basis by the Federal Reserve Board ("FRB"), Office of the Comptroller of the Currency ("OCC"), and Federal Deposit Insurance Corporation ("FDIC").

[7] Primary dealers must satisfy standards of reputation, capacity, and adequacy of staff and facilities in order to be designated as such, and they report their transactions to the Federal Reserve Bank of New York.

[8] 77 Fed. Reserve Bull. A30 (May, 1991) (Table 1.42).

II. DEVELOPMENT OF THE GOVERNMENT SECURITIES ACT

When the Government Securities Act was enacted, Congress was justifiably wary of over-regulating such a key market and imposing unnecessary costs. Accordingly, Congress fashioned a limited regulatory system designed to utilize existing regulations where possible, and to assure that all government securities brokers and dealers were brought under a regulatory system that could guard against a recurrence of the repurchase agreement-related abuses of ESM and Bevill Bresler.[10] Under the legislation, the Treasury was given authority to write rules concerning financial responsibility and associated recordkeeping and reporting requirements. In drafting these rules on capital and recordkeeping, Treasury was directed to consider the sufficiency and appropriateness of existing laws and to consult with and consider the views of the Commission and the Board of Governors of the Federal Reserve System ("FRB"). In implementing this rulemaking authority, Treasury for the most part adopted existing Commission regulations or, in the case of net capital, adapted existing FRB guidelines.

---

[9] Board of Governors of the Federal Reserve System, Flow of Funds Accounts, Third Quarter, 1990.

[10] S. Rep. No. 426, 99th Cong., 2d Sess. 14, 16, 20 (1986).

The Government Securities Act also required the newly regulated government securities dealers to register with the Commission and to become members of a self-regulatory organization. Registered broker-dealers and financial institutions were to be supervised by the SEC or the relevant banking agency, which was to receive notice of any such firm's status, examine for violations, and enforce compliance with the new Treasury rules.

III. SUMMARY OF RECOMMENDATIONS

The Treasury has carried out its responsibilities under the Government Securities Act effectively, and its rules have met the objectives established by Congress in enacting the Act.[11] As we stated in the Joint Report--

> The rules have been timely and fairly implemented; have not imposed excessive and overly burdensome requirements; have not impaired the liquidity, efficiency and integrity of the government securities market; and have improved and strengthened investor safety in the market.[12]

Accordingly, we recommend that the Treasury's rulemaking authority under the Government Securities Act should be reauthorized.

---

[11] Joint Report of the Department of the Treasury, Securities and Exchange Commission, and Board of Governors of the Federal Reserve System, Study of the Effectiveness of the Implementation of the Government Securities Act of 1986, October, 1990, ("Joint Report").

[12] Id. at iv.

In addition to reauthorization of Treasury's existing authority, there are three other issues that are under consideration. These issues are (i) the proper framework for a trade and quotation reporting system to enhance market transparency, (ii) sales practice oversight and (iii) SIPC coverage.

A market is "transparent" if information about transactions and quotations in the market is promptly and publicly available. Transparency improves pricing efficiency, the relationship between quoted prices and the prices at which securities actually trade. It also allows an investor to compare the prices he or she is asked to pay with the prices their dealer pays.

Private sector initiatives have progressed significantly in developing a prototype reporting system for the government securities market. However, without legislation there can be no assurance that the proposed system will be implemented, or that if implemented, it will continue to provide reliable information in a timely manner. The proposed GOVPX system, developed by the Public Securities Association ("PSA"), represents a major step towards serving the needs of investors for market information regarding government securities transactions and quotations. Developed by the private sector, GOVPX will, if it commences operation next week as planned and remains in operation with high levels of dealer participation, materially improve market transparency for investors. However, in its current format the system will not provide certain types of important information.[13]

Second, under current law there is a loophole in the rulemaking authority of the National Association of Securities Dealers ("NASD"). This loophole prevents the NASD from applying its sales practice standards to the government securities activities of the dealers it oversees. Sales practice rules address abuses such as excessive mark-ups, unauthorized trading, unsuitable recommendations, cold calling practices and churning of customer accounts. These abuses are not specific to the type of security or the identity of the issuer. Rather, they apply solely to the conduct of the broker or dealer, which, in the large majority of cases, is already subject to the same NASD sales practice standards for other securities. Accordingly, eliminating this loophole is a reasonable way to improve investor protection while taking advantage of the flexibility and sensitivity to market costs that is inherent in the system of self-regulation.

Finally, there is the issue of whether, and under what conditions, Securities Investor Protection Corporation ("SIPC") coverage should be extended to the 64 firms registered under Section 15C of the Securities Exchange Act of 1934 ("Exchange Act"). These firms are not currently eligible for SIPC membership because they are separately registered and regulated as specialized government securities brokers and dealers.

---

[13] For example, GOVPX will only cover Treasury securities, not all the other types of government securities discussed above. GOVPX will not include all the interdealer brokers, resulting in coverage of only about 75% of the interdealer market in Treasury securities. GOVPX will only provide the best bid and the offer which accompanies that bid, not the best offer itself.

In addition to the Commission's recommendation that the Treasury's current financial responsibility rulemaking authority be extended, the Commission recommends that Congress give the Commission limited authority to assure the transparency of the government securities market. As described more fully below, the Commission does not believe that extensive new regulation of trade reporting systems is required to assure improved market transparency in light of the development of GOVPX. We would prefer to see GOVPX implemented, tested and expanded to fill certain obvious gaps over the next 12-18 months. During this time, Congress should authorize the Commission to monitor implementation of GOVPX and to work with its participants in considering enhancements. Unless identified operating benchmarks are not attained, a new regulatory program should not be required except on a standby or "backstop" basis. This latter authority would allow the SEC to promulgate rules only where the private system failed to provide the expected improvements in transparency to the government securities market. Since the Commission already has similar authority under the Exchange Act with respect to equity and corporate debt markets, it can play a backstop role without significant additional expense. Creating the capability for such oversight of trading systems at the Treasury Department, which does not have any existing responsibilities for market transparency, could impose new staffing and budget requirements.

Similarly, as described below, the Commission has not determined that there is a level of existing sales practice abuse in the government securities market sufficient to justify a burdensome new regulatory program to address such abuses. Rather, we think that there is a potential for problems in this area that should be forestalled by eliminating the current gap in the NASD's authority. As with transparency, this step would not require significant expense or regulatory costs.

Finally, we believe the SIPC question deserves further study, but that comparable regulation of all SIPC members is essential for the protection of the SIPC fund.

IV. TRANSPARENCY IN THE GOVERNMENT SECURITIES MARKET

The Commission believes that there should be broad access to real-time pricing information from all government securities brokers and dealers. This information should include both transaction information, including price and volume, and quotation information. Access to such information would enhance the ability of investors to evaluate the fairness of executions proposed by primary and aspiring primary dealers, who currently have exclusive access to the most comprehensive pricing information. It would also enhance investors' confidence in the pricing efficiency of this key market.

The Commission believes that these benefits can be obtained without diminishing market liquidity. Given the high level of volume in the government securities market, the Commission does not believe that there is a real likelihood that accurate last-sale or quotation information would increase significantly the risks borne by dealers taking substantial positions. Therefore, we see no reason for continuing to limit the distribution of trade and quote information.[14]

The Commission has long been in the forefront of the call for improved transparency in the government securities market. Since 1987, the Commission has been on record in calling for action to assure the success of private sector efforts to improve transparency.[15]

In response to these concerns, on January 16, 1991, PSA announced that a joint venture of primary dealers and interdealer brokers had established a system called

---

[14] Concerns that liquidity in the OTC equity market would be adversely affected by increased transparency were addressed by a phased-in approach to increasing transparency. Although there are substantial distinctions between the OTC equity market and the government debt market, we believe that similar techniques could address any liquidity concerns of the dealer community.

[15] In its comment letter to GAO on its report, entitled U.S. Government Securities, An Examination of Views Expressed about Access to Brokers' Services ("1987 Report"), the Commission stated that expanded access to the information contained on interdealer brokers' screens would be in the public interest; however, the Commission disagreed with GAO's conclusion that interdealer brokers, with the acquiescence of the primary dealers, necessarily would achieve this result voluntarily. Accordingly, the Commission concluded that resistance to information dissemination among primary dealers, coupled with potential issues concerning the possible proprietary nature of transaction and quotation information, mitigated against reliance on voluntary action by the interdealer brokers and primary dealers to achieve this result.

The 1990 GAO Report contained a description of several unsuccessful efforts by interdealer brokers to provide greater access to information in their possession. It recognized that the concerns expressed by the Commission in 1987 about voluntary cooperation by primary dealers to expand access appeared justified. In light of the failure of these private sector initiatives and the potential for continued dealer resistance, the GAO concluded in its most recent report on government securities that Federal regulation is necessary and appropriate.

GOVPX which promises to bring substantial transparency to a key sector of the government securities market. Beginning June 16, GOVPX is expected to distribute anonymous last-sale prices and volume information, and best bids (and the offers accompanying those best bids), on all U.S. Treasury bills, notes, and bonds. GOVPX will receive price information from five of the six interdealer government securities brokers, covering approximately 75% of the interdealer market. GOVPX will disseminate to vendors a composite picture of dealer activity, showing executed trade prices, volume of executed trades, best bids (and the offers accompanying those best bids), yields, and running aggregated volumes traded in each security on a daily basis.

This is a substantial improvement in information dissemination, and we applaud and welcome the PSA's initiative. Nevertheless, we have some remaining concerns. For example, the information to be provided by GOVPX will not be as complete as information available to primary dealers and aspiring primary dealers through the interdealer brokers' screens. GOVPX will cover only Treasury securities, not other government securities;[16] it will provide only the offers accompanying the best bids (and not the best offers); and it will not include the size associated with published bids and offers. Further, GOVPX will not include the other bids and offers available in the market, and users will not be able to access or store data electronically for analytical purposes. Finally, GOVPX disseminates only the quotations placed with participating interdealer brokers. It will not cover the other 25% of the interdealer market, nor will it disseminate last-sale prices, volume, and quotations from government securities dealers if an interdealer broker is not utilized.

---

[16] Without legislation, there also can be no assurance that other potential systems can be integrated with GOVPX so that vendors of securities information and investors can be assured of achieving full market transparency on a consolidated basis.

The PSA initiative, if it continues to develop to meet the information needs of the investors and market participants, as well as other market information initiatives, ultimately may obviate the need for government intervention. Nevertheless, we believe it is advisable that Congress set forth in legislation a backstop to private-sector efforts in this area to ensure that the public policy objectives underlying the call for improved government securities market transparency are attained. Any such backstop legislation should give the private sector an opportunity to continue its leadership in the development of transparency systems.

The "backstop" regulator should be given the authority to address any serious problems, such as the failure of GOVPX or the inability of its participants to agree on needed modifications. Such authority would parallel the Commission's current authority under Sections 11A and 17(a) of the Exchange Act to mandate transparency for national market system securities.[17]

---

[17] See, e.g., Section 11A(c)(1)(D) of the Exchange Act, which authorizes the Commission, in connection with the Congressional directive to facilitate the establishment of a national market system for securities, to assure that all persons "may obtain on terms which are not unreasonably discriminatory such information with respect to quotations for and transactions in such securities as is published or distributed by any self-regulatory organization or securities information processor"; and Section 17(a) of the Exchange Act, which authorizes the Commission to require every registered broker or dealer to make and disseminate such reports as the Commission prescribes as necessary or appropriate in the public interest.

Under such a "standby" or "backstop" regulatory system, the statute could condition the exercise of regulatory authority on a finding by the regulator that there is inadequate disclosure or dissemination of information with respect to quotations for, and transactions in, government securities. The statute could further require that the regulator's finding be based on a consideration of the extent to which the following are made available on a fair, reasonable, and non-discriminatory basis: (1) timely reports of the price and volume of transactions effected by government securities brokers and dealers, (2) timely reports of quotations, with the size at which government securities dealers are willing to trade, and (3) timely reports of the highest bids and lowest offers from among all government securities dealers. Under such an approach, legislative history would specify the goals, such as dissemination of information on all government securities, that Congress intended the private-sector systems to achieve by the expiration of the specified time period. Absent a failure of GOVPX to meet such specified criteria, "backstop" federal regulation should not be triggered at all.

The Commission is well equipped to implement this backstop authority, as it has substantial experience and existing expertise in facilitating real-time transaction and quotation reporting, primarily in the markets for equity securities.[18] The Commission would be able to utilize its experience in other markets to maintain the expertise necessary to monitor developments in GOVPX and the government securities markets generally. Thus, with a largely existing capability, the Commission would be able to monitor the development of the private sector system without incurring significant new costs. The Commission could also take any necessary action should GOVPX fail to achieve the goals established by Congress. Using an existing staff would also be most effective and efficient if Congress were to specify a time period to permit the private sector to perfect its system without regulation but with the knowledge that a backstop regulator was actually monitoring developments.

---

[18] The Commission, under the authority provided it in Sections 11A and 17(a) of the Exchange Act, has extensive experience working with the securities markets to develop more efficient mechanisms for assuring the widespread availability of transaction and quotation information. In the area of equity trading, the Commission has worked with the exchange and OTC markets to develop, respectively: (1) a consolidated reporting system for real-time transaction and quotation information that ensures that trades and quotes in any exchange-traded security, wherever they occur in the United States, are available on a real-time basis; and (2) last-sale reporting of trades in the OTC market. Moreover, in (continued...)

In the event that Congress determined to give the Commission such "backstop" authority, the Commission should be required to consult with and to consider the views of the Treasury and the FRB as to transparency issues. If either comments in writing, the Commission could be required to respond in writing before adopting any rule. This process would assist in striking the proper balance between strengthening customer protection and ensuring the continued liquidity and efficiency of the market.

---

[18](...continued)
carrying out the Congressional directive to facilitate the establishment of a national market system for securities, the Commission has gained valuable experience in addressing problems specific to the dissemination of real-time quotation and transaction information -- that is (among other issues), ensuring that securities information processors have access to that information on terms that are fair and not unreasonably discriminatory, and encouraging different trading markets to work together to develop national market system plans in order to avoid duplication of effort.

V. RULES GOVERNING SALES PRACTICES

Currently, there is a gap in sales practice regulation of government securities brokers and dealers that are only NASD members. Sales practice rules adopted by self-regulatory organizations ("SROs") require adherence to "high standards of commercial honor and just and equitable principles of trade." [19] They address abuses such as excessive mark-ups, adjusted trading, unauthorized trading, unsuitable recommendations, and churning of customer accounts. [20]

For example, the NASD's "mark-up rule" requires that a member engaging in a principal transaction "buy or sell at a price that is fair." [21] The rule assures customers the price they pay is a market price. The rule protects individual customers who do not have access to market information, and it prohibits "adjusted trading" where the dealer and customer sell securities to each other at above-market prices to permit an institutional customer that does not mark its portfolio to market to defer recognition of losses.

---

[19] See, e.g., Article III, Section 1 of the NASD's Rules of Fair Practice, NASD Manual (CCH), at ¶ 2151.

[20] Although sales practice rules generally prohibit conduct that has also been held to violate Exchange Act Rule 10b-5, enforcement of sales practice rules by the SROs, unlike enforcement of Commission antifraud rules, generally requires no explicit showing that the respondent acted with scienter, or intent to defraud. See, e.g., In re Eugene J. Erdos, 47 S.E.C. 985 (1983), aff'd, 742 F.2d 507 (9th Cir. 1984) (showing of scienter not required in order to establish that respondent broker-dealer violated Article III, Section 2 of the NASD's Rules of Fair Practice, prohibiting excessive trading in a customer's account). The term "scienter," as applied to conduct necessary to give rise to an action for civil damages under the Exchange Act and Rule 10b-5, refers to a mental state embracing intent to deceive, manipulate, or defraud. Ernst and Ernst v. Hochfelder, 425 U.S. 185 (1976).

[21] Article III, Section 4 of the NASD Rules of Fair Practice, NASD Manual (CCH), at ¶ 2154.

The SRO rules also prohibit members from making improper use of a customer's securities or funds. [22] These rules prohibit registered representatives from engaging in transactions without customer authorization or sending confirmations for transactions not actually agreed upon ("unauthorized trading").

The NASD's "suitability rule" and the New York Stock Exchange's ("NYSE") "know your customer rule" require that a dealer who recommends a transaction to a customer have a reasonable basis for believing the recommendation is suitable for the customer, based on the facts disclosed by the customer as to his other security holdings and his financial situation and needs. [23] This means that a salesman cannot ignore his customer's financial circumstances and recommend the purchase of a stripped mortgage-backed security when a Treasury bond would be more appropriate.

The Commission also has adopted rules targeted at preventing sales practice abuse. [24] For example, it has adopted rules that prohibit churning of customer accounts and rules that establish strict requirements for selling penny stocks through the use of "cold calls."

---

[22] Article III, Section 19 of the NASD Rules of Fair Practice, NASD Manual (CCH), at ¶ 2169.

[23] Article III, Section 2 of the NASD Rules of Fair Practice, NASD Manual (CCH), at ¶ 2152; NYSE Rule 405, "Diligence as to Accounts," NYSE Manual ¶ 2405, at 3697.

[24] See Rules 15c1-1 through -9 and Rules 15c2-1 through -12.

Most sales practice rules are applicable to transactions in a broad range of securities.[25] This is because sales practice abuse has less to do with the security sold than with the marketing approach of the broker-dealer and its associated persons. Many investors routinely consider investments in both corporate and governmental debt securities, as well as corporate equities, at the same time. Sales practice rules generally should focus on the marketing activity, not the type of security.

Currently, there is a patchwork of sales practice rules applicable to the government securities activities of some participants in the government market. Specifically, sales practice rules promulgated by the NYSE and other national securities exchanges apply to the government securities activities of the members of those exchanges. In contrast, members of the NASD are not subject to any sales practice rules applicable to their government securities business. Rather, they are subject only to the antifraud provisions of the federal securities laws, primarily Rule 10b-5 under the Exchange Act.

---

[25] The exception is the penny stock "cold calling" rule, Exchange Act Rule 15c2-6. That rule, like many SRO options rules, imposes greater costs than would be warranted for the full range of securities. Penny stock and options rules impose more stringent and specific standards than the rules described above and, accordingly, are applied only in the area where the costs imposed by those rules are warranted by the potential for abuse.

Dealers that are financial institutions are subject to broad safety and soundness standards that apparently have allowed bank examiners to apply relevant sales practice standards from other markets to conduct in the government market. [26] Accordingly, only the salesman is likely to know whether his conduct in recommending a government security, no matter what its risks, is subject to much less scrutiny than if a corporate security is recommended. Only the dealer will know if its markups of government securities, which should be lower than for most corporate securities, will not be scrutinized if they are the same as those that are permissible for corporate securities.

There have been some sales practice abuses in the government securities market. The NASD has brought several disciplinary actions for fraudulent sales practices in connection with the sale of government securities. [27] Nevertheless, the SEC's own broker-dealer examination program has not found significant sales practice abuse by broker-dealers selling government securities.

---

[26] Joint Report at 79 n. 60.

[27] In the last three fiscal years, the NASD has brought 13 disciplinary actions against 11 firms and/or individuals associated with those firms for sales practice abuses involving government securities or options on government securities that are exempted pursuant to Exchange Act Rule 3a12-7. The abuses included churning, adjusted trading, excessive markups and markdowns, and unsuitable recommendations. Although the NASD does not have legal jurisdiction to take action against sales practice abuses that cannot be proven fraudulent, four cases, three of which were related, were settled solely on violation of NASD rules which are legally inapplicable to exempted securities. Expanding NASD sales practice authority over government securities dealers would give the NASD the ability to settle cases on lesser charges than violation of the antifraud provisions.

The NASD does have authority to discipline its members for advertisements involving government securities that are false or misleading, but not fraudulent. *See* Section 15A(f)(2) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78*o*-3(f)(2).

In view of the size of the government securities market, it is difficult to conclude that fraud and abuse in the government securities market have increased materially or that such practices have impacted investor confidence in any way that would affect the efficiency and liquidity of the market as a whole. Nonetheless, the market for government securities increasingly encompasses instruments that can pose considerably greater risk of adverse price movements than traditional investments in Treasury or agency securities. These new instruments include stripped mortgage-backed securities and zero coupon securities, which are economically quite similar to non-exempt instruments already covered by sales practice rules. Furthermore, strategies that combine government securities with options or futures or repurchase transactions can also significantly increase an investor's risk of loss. Because of the complexity of these investments and strategies, there is an opportunity for sales practice abuse, and the ability of investors to detect abusive tactics may be reduced. Similar opportunities for abuse in connection with non-exempted securities are effectively constrained by self-regulatory organization sales practice rules.

The Commission is concerned with the impact of abusive practices on the individuals and entities who have been the victims of such practices, particularly in products such as stripped securities that are more volatile than other Treasury securities, or in strategies that depend on the use of leverage, e.g., through the purchase or sale of government securities in combination with repurchase transactions, [28] options, or futures. However, the Commission has not recommended expansion of its own sales practice authority under Section 15(c) of the Exchange Act[29] because there has not been a significant increase in abuses that would justify recommending additional direct Commission rulemaking authority at this time. Similarly, independent financial institution supervisors have indicated that there is little abuse among the dealers they regulate, and that it does not appear necessary to develop a regulatory scheme for sales practices at such institutions at this time. [30] In contrast, the NASD has requested removal of the limitations on its authority to adopt rules regulating sales practices involving government securities. [31]

Although fraudulent activity associated with government securities transactions can be prosecuted under the Commission's antifraud rules, the Commission supports the NASD's request that the restriction on its sales practice authority over government securities be removed.[32] This would eliminate any potential that securities law violators will gravitate to the government securities market as a safe-haven for those who would perpetrate petty sales practice abuse. More importantly, it would permit the NASD, which has the experience in the sales practice area and an ongoing relationship with its members, to fill the gap in regulation.[33] It would not require the addition of new federal staff since the NASD operates under an existing regulatory system that has worked extremely effectively. The alternative of creating a new staff within the Treasury Department to develop new sales practice regulations is much less desirable.

---

[28] For example, there are situations where a government security is sold to an institution and financed by a repurchase agreement with the selling dealer. See In the Matter of Marsh & McLennan Companies, Inc., Securities Exchange Act Release No. 24023 (January 22, 1987).

[29] The Commission has recently utilized its authority under Section 15(c)(2) of the Exchange Act to adopt the "cold calling" rule, Rule 15c2-6, to constrain abuses in the penny stock market.

[30] Letter from William Seidman, Chairman, Federal Deposit Insurance Corporation, to Senator Christopher J. Dodd, Chairman, Securities Subcommittee, Senate Committee on Banking, Housing, and Urban Affairs, January 23, 1991, at 1.

[31] Under Section 15A(f)(1) of the Exchange Act, the NASD generally is prohibited from adopting and implementing rules applicable to transactions by a registered broker or dealer in exempted securities.

Removing the restriction on the NASD's rulemaking authority is the appropriate response to the concerns in the sales practice area. The NASD and the NYSE have recommended this approach.[34] The American Bankers Association ("ABA") also supports this approach. In its letter to Chairman Dodd commenting on sales practice rules, the ABA stated that:

---

[32] The NASD has requested removal of the limitations on its authority to promulgate and enforce rules of fair practice in the government securities area. It argues that such authority would relieve investigative and litigation burdens currently imposed by the need to proceed under Commission rules -- particularly Rule 10b-5. See letter from Joseph Hardiman, President, NASD, to Senator Christopher J. Dodd, Chairman, and Senator John Heinz, Ranking Minority Member, Securities Subcommittee, Senate Committee on Banking, Housing, and Urban Affairs, February 1, 1991 ("NASD letter"), at 3-4.

[33] GAO has supported expanded NASD authority to promulgate and enforce compliance by government securities brokers and dealers with Commission-approved fair practice rules, especially in the areas of markups, suitability, and churning. It has indicated that the NASD as an SRO should have the authority to promulgate and enforce Commission-approved sales practice rules in its oversight of the government securities market.

[34] NASD letter, at 3-4; letter from Richard A. Grasso, Executive Vice Chairman, NYSE, to Senator Christopher J. Dodd, Chairman, and Senator John Heinz, Ranking Minority Member, Securities Subcommittee, Senate Committee on Banking, Housing, and Urban Affairs ("NYSE letter"), at 2.

> rather than duplicate the compliance programs already in place and, by all accounts, operating successfully, an alternative may be for the Congress to simply remove that prohibition in the GSA that prevents the NASD from applying sales practice rules to government securities transactions. [35]

Expansion of the NASD's authority in the sales practice area is also consistent with the overriding purpose of self-regulation. The legislative history preceding the Securities Acts Amendments of 1975, [36] in reaffirming the system of self-regulation, cited, as an advantage "the expertise and intimate familiarity with complex securities operations which members of the industry can bring to bear on regulatory problems, and the informality and flexibility of self-regulatory procedures." [37] Conferring regulatory authority in the sales practice area to a self-regulatory organization would be consistent with Congress' prior deference to the expertise and flexibility of market participants.

This approach is also the most cost-effective. As noted above, sales practice abuses are not security-specific. Accordingly, rules should be written consistently across products with special provisions only to deal with real market differences or specific abusive potential associated with a particular type of security. This will reduce the training and compliance costs of dealers and will increase the likelihood of compliance, since basic sales practice rules are already known and understood by the sales force of integrated securities broker-dealers.

---

[35] See Letter from James McLaughlin, Director, American Bankers Association, to Senator Christopher Dodd and Senator John Heinz, Securities Subcommittee, Senate Committee on Banking, Housing, and Urban Affairs, January 25, 1991, at 4.

[36] Pub. L. No. 94-29, 89 Stat. 97 (June 4, 1975).

[37] Securities Industry Study Report of the Subcommittee on Securities, Senate Committee on Banking, Housing & Urban Affairs, S. Doc. No. 93-13, 93rd Cong., 1st Sess. 149 (1973).

Such an approach is also consistent with movement toward "functional regulation" of securities activities. As a general matter, the Commission believes that functional regulation can provide important benefits by promoting efficiency, effectiveness and consistency among different types of organizations providing a similar service. This principle was a key element of the recommendations of the Bush Task Group on Regulation of Financial Services.[38] Its importance has been more recently noted in the Department of the Treasury report, Modernizing the Financial System: Recommendations for Safer, More Competitive Banks. Under functional regulation, the regulations applicable should depend upon the category of product or the activity involved, not on the identity of the issuer.

VI. EXPANDING REQUIRED SIPC COVERAGE

The third area in which amendments have been considered is whether and under what conditions the Securities Investor Protection Act of 1970 ("SIPA") [39] should be amended to require that insurance coverage provided by the SIPC be extended to customer accounts held by non-bank "specialized" government securities brokers and dealers not now subject to the SIPA. [40]

---

[38] Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services, July 1984, at 91.

[39] 15 U.S.C. 78aaa *et seq*.

Under Section 3(a)(2)(A) of the SIPA, all brokers or dealers registered under Section 15(b) of the Exchange Act are required to be members of SIPC unless subject to a specific exemption. "Specialized" brokers and dealers registered under Section 15C of the Exchange Act, whose securities business is limited to U.S. government and other exempt securities (except municipal securities), are not permitted to become members of SIPC. Accordingly, where a diversified securities firm registered pursuant to Section 15(b) of the Act has an affiliated specialized government securities broker-dealer registered pursuant to Section 15C of the Act, the Section 15(b) firm is a member of SIPC, whereas the Section 15C firm is not. Some of these specialized dealers share the same office space and personnel with their diversified affiliates. Such a shared arrangement can keep customers from appreciating that transactions with different affiliates may carry different protection. In order to eliminate this confusion and to ensure additional investor protection, the GAO recommended that specialized government securities brokers and dealers be required to become members of SIPC.

---

[40] GAO recommended that Congress amend the Exchange Act to require that all non-bank specialized government securities dealers "provide SIPC coverage if their business with customers is similar to that for which SIPC coverage normally applies in SEC-registered securities markets." Report, at 64.

SIPC and the Commission believe that all broker-dealers covered by SIPC should be comparably regulated.[41] Currently, while the Treasury and the Commission establish comparable federal agency financial responsibility rules, there is a gap in NASD regulation of such broker-dealers. Accordingly, if Congress determines to require SIPC membership for specialized government securities brokers and dealers, it should also eliminate the limitations on the authority of the NASD to promulgate rules, including testing and financial responsibility requirements, such as bonding and maintenance margin requirements, for transactions in exempted securities (other than municipal securities).

These rules protect the SIPC fund as well as investors. Government securities brokers and dealers who are SIPC members should be subject to substantially similar protective requirements as those currently applicable to all other SIPC member firms. While the Commission and the Treasury capital and customer protection rules are the cornerstones of a strong financial responsibility program, NASD rules are designed to protect the integrity of the broker-dealer's financial resources. Fidelity bonding provides protection in the event of theft, embezzlement, or similar activity with respect to the property of the broker-dealer. Margin maintenance rules would tend to discourage imprudent credit extensions. Testing requirements are designed to preclude the entry into the business of persons who do not meet minimum standards of knowledge and competence and are relevant to the financial responsibility of the government securities broker-dealer insofar as they require the person responsible for a firm's financial responsibility to demonstrate familiarity with those requirements.

---

[41] See Letter from Theodore H. Focht, President and General Counsel, SIPC, to Richard L. Fogel, Assistant Comptroller General, GAO, June 27, 1990, at 2-3; Letter from Theodore H. Focht, President and General Counsel, SIPC, to Senator Christopher J. Dodd and Senator John Heinz, Securities Subcommittee, Banking Housing, and Urban Affairs, February 7, 1991, at 3.

Furthermore, we share SIPC's concern that any Congressional action in this area make clear that repurchase agreements are not included in SIPC coverage. The insurance fund has not been structured to bear those risks. Nevertheless, one federal court has suggested that some repurchase agreement customers are entitled to SIPC protection.[42]

VII. CONCLUSION

The Commission recommends that the Treasury's rulemaking authority under the Government Securities Act be reauthorized. The Commission also recommends that Congress give the Commission "backstop" authority to assure transparency in the government securities market, and that Congress remove the restriction on the application of the NASD's sales practice rules to the government securities market.

The Commission believes that there has been substantial progress in improving the transparency in the market for government securities. Private sector initiatives in this area should be maintained and improved. In our view, there should be broad access to real-time pricing information from all government securities brokers and dealers for all government securities. This information must be accessible and useful. It should include all of the information currently available to primary dealers, and the systems that provide it should have the incentive and the capacity to evolve to meet other market information needs for both transaction information, including price and volume, and quotation information.

---

[42] Cohen v. Army Moral Support Fund (In re Bevill, Bresler & Schulman Asset Management Corporation), 67 B.R. 557 (D.N.J. 1986).

The Commission recommends that Congress give the private sector the opportunity and motivation to continue to develop initiatives to meet these goals by enacting backstop legislation. Because of its expertise in facilitating real-time transaction and quotation reporting, primarily in the markets for equity securities, the Commission is in a unique position to monitor private sector initiatives and react as appropriate.

The Commission also believes that the best approach to the potential for sales practice abuse raised by the NASD would be for Congress to remove the restriction on the NASD's authority to promulgate and enforce rules to promote just and equitable principles of trade in the sales practice area. Providing this authority to the NASD would enhance investor protection by eliminating investor confusion about the scope of applicable regulatory protection, and is consistent with the purpose of self-regulation and Congress's prior deference to the expertise and flexibility of market participants. Further, expanding NASD authority would avoid the creation of a new sales practices regulator and be consistent with the movement toward functional regulation of securities activities.

Senator **Gramm**. Well, Chairman Breeden, I'll pass on to Senator D'Amato, your view as to the absurdity of his statement. [Laughter.]

I don't know where anybody would get an idea that there are or have been turf disputes. [Laughter.]

But in any case, let me now turn to Governor LaWare for his statement.

OPENING STATEMENT OF JOHN P. LaWARE, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE

Mr. **LaWare**. Thank you, Mr. Chairman.

We appreciate the opportunity to give our views regarding possible amendments to the Government Securities Act of 1986.

At the outset, let me note that the Federal Reserve Board continues to support the recommendations of the joint Treasury/SEC/Board study, most importantly, that Congress extend Treasury's rulemaking authority over the market beyond the current sunset date.

The experience of the past several years can, in our view, be read as ratifying the importance and usefulness of the Government Securities Act, and of the rules Treasury has promulgated under the authority that that act granted it.

In its capacity as rulemaker, the Treasury has effectively addressed the concerns about the maintenance of a fair, honest, and liquid market that motivated the original legislation.

Thus, in light of both its experience and its special expertise in this market, the Department of the Treasury should retain its current authority to write the rules in the market for Government securities.

Before getting into the specifics of other suggested amendments, I would like to lay out the Board's frame of reference in approaching this issue.

Specifically, we begin from the premise that it is absolutely essential to preserve the extraordinary liquidity and efficiency of the Government securities market.

This liquidity both facilitates the implementation of monetary policy through open market operations, and allows the Treasury to issue Federal debt at the lowest possible cost to the taxpayers.

The investors accept a lower rate of return on Government securities in part because they know this market is deep and broad and liquid. Large transactions can be made quickly with relatively little effect on prices, and can, if necessary, be reversed just as quickly with relatively low transaction costs.

While we view market liquidity as essential, this is not to say that investor protection is not also a legitimate concern. It is an important concern in its own right. And if not adequately addressed, a loss of investor confidence in the fairness and functioning of the Government securities market could itself impair liquidity.

But any securities regulation involves cost, directly to the issuer, customer, or dealer, as well as indirectly by potentially diminishing the general liquidity of the market.

Consequently, in weighing the advisability of legislation to add new regulation, the Congress will, of course, want to assure itself that the expected benefits of any new regulation exceed the associated expected costs.

Several years ago when drafting the Government Securities Act, the Congress explicitly considered the case for broader regulation of sales practices and some other areas, but chose not to make it a part of the act.

In the Board's view, a convincing case for calling this decision into question has not yet been made.

In the area of sales practice rules, the General Accounting Office's report in September 1990 recommended that the Congress amend the Securities and Exchange Act to authorize a Federal agency to adopt rules of fair practice applicable to all Government securities brokers and dealers, addressing, at a minimum, dealer markups and investor suitability requirements.

The Treasury's proposed legislation would do just that, and would designate the Treasury itself as the Federal agency in charge with quite broad powers in this area.

In taking a closer look at these proposals, our experience in applying markup rules elsewhere suggests that there are significant difficulties and ambiguities in administering such rules fairly.

Even if judgments about the reasonableness of markups in this fast-paced market could be made on an ex post basis, it could be difficult to formulate meaningful criteria for use in making ex ante judgments and providing guidance to dealers.

The Government securities market spans a wide range of securities from the extremely liquid so-called on-the-run Treasury securities where bid-ask spreads are razor thin, to the more exotic and sometimes tailormade hybrids and derivatives where a fair markup could be very sizable.

In the same vein, the Board is concerned that suitability rules could impose a burden on the Government securities market by adding to cost, delaying the execution of transactions and potentially limiting the range of legitimate investments available to a dealer's customers.

Moreover, many of the losses in the Government's securities markets cited by the GAO and others in support of sales practice rules have involved large investors whom one would expect to have the sophistication to judge the appropriateness of various investments themselves.

It's doubtful that any suitability rules should apply to those best described as institutional investors.

There are nevertheless concerns that smaller and perhaps less sophisticated investors may at times been subjected to high pressure sales tactics and sold inappropriate investments.

As the regulator of State-chartered member banks, some of whom have been the targets of such practices, the Board is aware of this possibility.

And in 1988 the Board, along with the other bank regulatory agencies, adopted a policy statement regarding the selection of securities dealers and unsuitable investment practices.

The policy statement lists standards that institutions should apply when selecting a dealer, and describes the interest rate risk characteristics of several extremely volatile instruments such as stripped mortgage-backed securities, noting that such instruments cannot be considered suitable investments for the vast majority of depository institutions.

The adoption of the policy statement, together with an effort to educate banks to the risks involved, has virtually eliminated the problem for the banks that we regulate.

There are other investors for whom this would not be a practical or complete solution, however, and the Board recognizes that Congress may conclude that additional sales practice rules are desirable to help curb existing or potential abuses.

Senator **Gramm**. Governor LaWare, let me get you to hold, if I could.

I've got a vote going on here.

Senator Dodd was supposed to be back.

I think I'm just going to put us into a temporary recess until he gets back.

Mr. **LaWare**. I'll mark my place, because we wouldn't want you to miss the vote.

Senator **Gramm**. The committee will stand in recess. [Recess.]

Senator **Dodd**. All right, let us commence.

I understand that Mr. LaWare, you're right in the middle of your testimony, and hopefully these interruptions will be at a minimum before the afternoon is over.

We apologize for the interruption.

Mr. **LaWare**. Perhaps I'll go back to the beginning of the paragraph that I was in the middle of, if that's all right.

Senator **Dodd**. Oh, all right, the beginning of the paragraph. [Laughter.]

I know he wants to make his case, but—all right.

Mr. **LaWare**. There are other investors for whom this would not be a practical or a complete solution, however, and the Board recognizes that Congress may conclude that additional sales practice rules are desirable to help curb existing or potential abuses.

In that case, perhaps the least costly measure would be a simple removal of the prohibition on NASD applying its sales practice rules to Government securities transactions.

Allowing the NASD to apply its existing rules to Government securities sales by its members would parallel what is already the case for New York Stock Exchange member firms, and would extend coverage to all nonbank brokers and dealers.

In this process, which would in essence take place with oversight by the SEC, we would favor substantive consultation and cooperation with the Department of the Treasury, as the primary regulator of this market.

In our view, going further than this to cover bank dealers is unnecessary, given the lack of allegation of sales practice abuses involving these dealers.

Bank examiners routinely go through customer complaint files, and this is an area in which they simply have not been seeing complaints.

We believe that the bank supervisory agencies, through the use of frequent and detailed examinations, and other tools at their disposal, have the ability to identify any abuses quickly, should they develop.

The issue of whether legislation is needed to expand access to information about securities trading through interdealer brokers appears at present to be very nearly moot.

An independent corporation sponsored by the Public Securities Association and owned by the brokers and dealers is moving toward implementation of its plan to disseminate price and volume information on a fee basis in just a few days. I think June 16 is their target date.

We recognize that this initiative may have been motivated strongly by the possibility of legislative action. But we believe that so long as it is going forward, actual legislation and associated regulatory oversight are unnecessary and could constrain rapidly changing market practices.

Should this latest private sector initiative falter, however, or should the information prove inadequate, our view of the desirability of a legislative response would likely change.

With respect to the GAO recommendation that the Securities Investor Protection Corporation insurance be extended to customer accounts at registered Government securities brokers and dealers, there could be some marginal benefits in terms of customer protection, but other regulatory changes might be necessary in connection with the adoption of this proposal.

For example, SIPC has pointed out that the proposal raises major questions about regulatory oversight, because all current members of SIPC are subject to the full rulemaking authority of the SEC.

A range of related questions warrants further study before a definitive conclusion can emerge about the desirability of expanding SIPC coverage.

In sum, by instituting an effective and comprehensive regulatory structure, the Government Securities Act of 1986 appears to have largely accomplished its goals.

It is the Board's position that the need for additional legislation beyond that already proposed in the Treasury/SEC/Board study has not been decisively demonstrated.

Nevertheless, we would not stand in opposition to a modest broadening of the scope of regulation over this market through the removal of the prohibition of the NASD applying its existing sales practices rules to the Government securities activities of its members.

However, we would view substantial additional regulation as not only unnecessary but detrimental.

The creation of a whole new panoply of rules and regulations likely would prove an inefficient and potentially very costly way of dealing with the relatively few abuses that have occurred in this area.

Thank you, sir.

[Written statement of John P. LaWare follows:]

For release on delivery
2:00 p.m., E.D.T.
June 12, 1991

Testimony by

John P. LaWare

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Securities

of the

Committee on Banking, Housing, and Urban Affairs

U.S. Senate

June 12, 1991

Thank you for this opportunity to give our views regarding possible amendments to the Government Securities Act of 1986. At the outset, let me note that the Federal Reserve Board continues to support the recommendations of the joint Treasury-SEC-Board study--most importantly, that Congress extend Treasury's rulemaking authority over the market beyond the current sunset date. The experience of the past several years can, in our view, be read as ratifying the importance and usefulness of the Government Securities Act and of the rules Treasury has promulgated under the authority that Act granted it. In its capacity as rulemaker, the Treasury has effectively addressed the concerns about the maintenance of a fair, honest, and liquid market that motivated the original legislation. Thus, in light of both its experience and its special expertise in this market, the Department of the Treasury should retain its current authority to write the rules in the market for government securities.

Before getting into the specifics of other suggested amendments, I would like to lay out the Board's frame of reference in approaching this issue. Specifically, we begin from the premise that it is absolutely essential to preserve the extraordinary liquidity and efficiency of the government securities market. This liquidity both facilitates the implementation of monetary policy through open market operations and allows the Treasury to issue federal debt at the lowest possible cost to the taxpayers. Investors accept a lower rate of return on government securities, in part because they know this market is deep and broad and liquid--large transactions can be made quickly with relatively little effect on prices and can, if need be, reversed just as quickly with relatively low transactions costs. While we view market liquidity as essential, this is not to say that investor protection is not also a legitimate concern. It is an important concern in its own right, and, if not adequately addressed, a loss of investor confidence in the fairness and functioning of the government securities market could itself impair liquidity.

But any securities regulation involves costs--directly to the issuer, customer, or dealer, as well as indirectly by potentially diminishing the general liquidity of the market. Consequently, in weighing the advisability of new legislation to add regulation, the Congress will, of course, want to assure itself that the expected benefits of any new regulation exceed the associated expected costs. Several years ago, when drafting the Government Securities Act, the Congress explicitly considered the case for broader regulation of sales practices and some other areas, but chose not to make it part of the Act. In the Board's view, a convincing case for calling this decision into question has not yet been made.

In the area of sales practice rules, the General Accounting Office's report in September 1990 recommended that the Congress amend the Securities Exchange Act to authorize a federal agency to adopt rules of fair practice applicable to all government securities brokers and dealers, addressing, at a minimum, dealer markups and investor suitability requirements. The Treasury's proposed legislation would do just that, and would designate the Treasury itself as the federal agency in charge, with quite broad powers in this area.

In taking a closer look at these proposals, our experience in applying markup rules elsewhere suggests that there are significant difficulties and ambiguities in administering such rules fairly. Even if judgments about the reasonableness of markups in this fast-paced market could be made on an ex-post basis, it could be difficult to formulate meaningful criteria for use in making ex-ante judgments and providing guidance to dealers. The government securities market spans a wide range of securities, from the extremely liquid, so-called "on-the-run" Treasury securities, where bid-asked spreads are razor-thin, to the more exotic and sometimes tailor-made hybrids and derivatives, where a fair markup could be sizable.

In the same vein, the Board is concerned that suitability rules could impose a burden on the government securities market by adding to costs, delaying the execution of transactions, and potentially limiting the range of legitimate investments available to a dealer's customers. Moreover, many of the losses in the government securities market cited by the GAO and others in support of sales practice rules have involved large investors, whom one would expect to have the sophistication to judge the appropriateness of various investments themselves. It is doubtful that any suitability rules should apply to those best described as institutional investors.

There are, nevertheless, concerns that smaller and perhaps less sophisticated investors may, at times, have been subjected to high-pressure sales tactics and sold inappropriate investments. As the regulator of state-chartered member banks, some of whom have been the targets of such practices, the Board is aware of this possibility, and in 1988 the Board, along with the other bank regulatory agencies, adopted a policy statement regarding the selection of securities dealers and unsuitable investment practices. The policy statement lists standards an institution should apply when selecting a dealer and describes the interest-rate risk characteristics of several extremely volatile instruments, such as stripped mortgage-backed securities, noting that such instruments "cannot be considered as suitable investments for the vast majority of depository institutions." The adoption of the policy statement, together with an effort to educate banks to the risks involved, has virtually eliminated the problem for the banks we regulate.

There are other investors for whom this would not be a practical or a complete solution, however, and the Board recognizes that Congress may conclude that additional sales practice rules are desirable to help curb existing or potential abuses. In that case, perhaps the least costly measure would be a simple removal of the prohibition on NASD applying its sales practice rules to government securities transactions. Allowing NASD to apply its existing rules to government securities sales by its members would parallel what is already the case for NYSE member firms, and it would extend coverage to all nonbank brokers and dealers. In this process, which would in essence take place with oversight by the SEC, we would favor substantive consultation and cooperation with the Department of the Treasury as the primary regulator of this market.

In our view, going further than this--to cover bank dealers--is unnecessary, given the lack of allegations of sales practice abuses involving these dealers. Bank examiners routinely go through customer complaint files, and this is an area in which they simply have not been seeing complaints. We believe that the bank supervisory agencies, through the use of frequent and detailed examinations and other tools at their disposal, have the ability to identify any abuses quickly, should they develop.

The issue of whether legislation is needed to expand access to information about securities trading through interdealer brokers appears at present to be very nearly moot. An independent corporation sponsored by the Public Securities Association and owned by the brokers and dealers is moving toward implementation of its plan to disseminate price and volume information on a fee basis in just a few days. We recognize that this initiative may have been motivated strongly by the possibility of legislative action. But we believe that so long as it is going forward, actual legislation and associated regulatory oversight are unnecessary and could actually constrain rapidly changing market practices. Should this latest private-sector initiative falter, however, or should the information prove inadequate, our view of the desirability of a legislative response likely would change.

With respect to the GAO recommendation that Securities Investor Protection Corporation insurance be extended to customer accounts at registered government securities brokers and dealers, there could be some marginal benefits in terms of customer protection, but other regulatory changes might be necessary in connection with the adoption of this proposal. For example, SIPC has pointed out that the proposal raises major questions about regulatory oversight, because all current members of SIPC are subject to the full rulemaking authority of the SEC. A range of related questions warrants further study before a definitive conclusion can emerge about the desirability of expanding SIPC coverage.

On a minor note, we question the Treasury's recommendation that the Act be amended to provide for information to be furnished to the Treasury directly by the Federal Reserve Banks, rather than through the Board of Governors, as it is now. Any information that the Treasury might need from the Federal Reserve to carry out its responsibilities under the Government Securities Act likely would be obtained through our supervisory authority, and the Board has detailed, well established procedures concerning the release of such information. The proposed rule change would be inconsistent with those procedures. Accordingly, in the absence of a clear need for such a change, we would oppose it.

Finally, committee staff has requested that we also address a recent episode in the Treasury coupon market, in which strong demands by a few participants apparently "squeezed" others in the market who had committed to deliver last month's two-year Treasury note. As a result, prices were distorted for a time in the market for the security and for its financing. In the wake of that incident, questions have arisen about whether current regulations provide adequate protection against the potential for manipulative practices in this market. As is the case for the other concerns being addressed here today, equitable and nondistorting regulations are not easy to design, and we would counsel caution in expanding regulation lest the cost to the taxpayer be excessive. Certainly, we do not want to interfere with strong bidding for securities that lowers the cost to the taxpayer of servicing the public debt. But if that strong bidding results in the perception that Treasury securities prices are arbitrary and subject to manipulation, marketmakers and investors could turn away from these instruments, impairing liquidity and ultimately lowering demand in the market with adverse effect on the cost to the government. Both the facts and the outlook in this area are worth studying further, and it may be that additional rules or reporting requirements will be found to be in order. At this point, however, no new legislation appears to be needed, and a range of possible responses could be implemented under the Treasury's existing authority.

In sum, by instituting an effective and comprehensive regulatory structure, the Government Securities Act of 1986 appears to have largely accomplished its goals. It is the Board's position that the need for additional legislation, beyond that already proposed in the joint Treasury-SEC-Board study, has not been decisively demonstrated. Nevertheless, we would not stand in opposition to a modest broadening of the scope of regulation over this market through the removal of the prohibition on the NASD applying its existing sales practice rules to the government securities activities of its members. However, we would view substantial additional regulation as not only unnecessary, but detrimental. The creation of a whole new panoply of rules and regulations likely would prove an inefficient and potentially very costly way of dealing with the relatively few abuses that have occurred in this area.

Senator DODD. Thank you very much.

Mr. Glauber, we welcome you.

OPENING STATEMENT OF ROBERT GLAUBER, UNDER SECRETARY FOR FINANCE, TREASURY DEPARTMENT

Mr. GLAUBER. Thank you, Mr. Chairman.

Legislation that we've submitted to Congress would further the original purposes of the GSA by strengthening customer protection, increasing investor confidence in the integrity of the Government securities market.

First, the proposed legislation would extend Treasury's existing rulemaking authority under the GSA.

Second, authorize Treasury to write sales practice rules for the Government securities market.

Third, authorize the NASD to adopt Government securities sales practice rules for its members.

Fourth, grant Treasury discretionary authority to prescribe rules for the dissemination of Government securities prices and volume information.

Fifth, make technical and conforming changes in the Securities and Exchange Act of 1934.

Let me turn to each of these pieces one by one.

With regard to the first, let me dispose of it quickly, that is, the extension of Treasury's rulemaking authority.

We would join the SEC and the Fed and the GAO in recommending the extension of rulemaking authority that presently exists.

With regard to sales practice rules, the GSA was enacted to correct those areas of documented abuse and weaknesses in the Government securities market that existed at that time.

The Treasury was not granted any authority to prescribe sales practice rules pertaining to transactions in Government securities because of the scope of the legislation.

Additionally, the GSA continued the restriction placed on the NASD that bars it from applying its sales practice rules to the Government securities transactions conducted by its members.

The magnitude and the severity of abusive sales practices in the Government securities market are difficult to assess, given the lack of specific evidence of widespread abuses.

Indeed, some of the well-publicized cases involving customer losses in Government securities transactions may not have stemmed solely from abusive sales practices.

However, the Government securities market is the only regulated securities market in the United States that does not have broadly applicable sales practice rules.

The same kinds of abuses that made sales practice rules necessary in the corporate municipal and penny stock markets may well occur in the Government securities market.

By applying sales practice rules to the Government securities market, investors would benefit from protection similar to that afforded to them in other markets.

Treasury clearly wants to prevent unscrupulous brokers and dealers who may have operated in these other markets until the advent of sales practice rules from moving into the Government securities market.

While the Government securities market remains principally a wholesale market, a significant number of smaller and less sophisticated investors are participating in the Government securities market because of their desire for high quality investments.

This market increasingly includes instruments that pose considerably greater price risks than traditional investments in Treasury and agency securities.

These instruments include mortgage-backed securities, including collateralized mortgage obligations issued guaranteed by the Government agencies, zero-coupon securities, and agency I/O's and PO's, as well as over-the-counter options.

Even though many of these securities are backed by a U.S. Government guarantee, unsophisticated investors may not fully understand their complexity and risks.

Granting Treasury rulemaking authority for sales practices pertaining to transactions in Government securities would be consistent with the regulatory structure set out under the GSA.

This regulatory approach would continue to use Treasury's expertise and position in the market to ensure that sales practice rules would strengthen customer protection and would not impair the liquidity or efficiency of the market. Nor would any such rules increase the cost of financing the public debt.

Additionally, vesting rulemaking authority with the Treasury would assure that the sales practice rules would provide comparable protection to customers for both bank and nonbank broker-dealers.

We also urge that Congress rescind the current restriction on the NASD's authority regarding sales practice rules. Such action would be consistent with Congress' prior decision to use the expertise and familiarity of self-regulatory organizations. It would also put to use the NASD's expertise and experience in implementing sales practice rules it has developed for other markets.

The extension of sales practice rules to the Government securities market will strengthen investor confidence in the market and will significantly enhance customer protection. Sales practice rules should not result in excessive burdens or significantly increased costs, because broker-dealers now must comply with such rules for their corporate and municipal securities activities while banks that conduct a business in municipal securities must comply with MSRB sales practice rules.

Sales practice rules proposed by Treasury will be designed so that the benefits in terms of customer protection will outweigh any increase in regulatory costs or burdens, which we believe would be minimal.

With regard to the access to Government securities price and volume information, Treasury supports expanded disclosure of and access to Government securities price and volume information. Expanded availability of such information would serve the public interest.

When broad spectrum of market participants can obtain current, accurate information on market conditions, the competitiveness, liquidity, and efficiency of the Government securities market should improve. Moreover, expanded information access would serve to enhance customer protection, since customers would be in a better position to determine actual or potential transaction prices for securities, especially for inactively traded issues, and to evaluate the fairness of trades being proposed by a broker or dealer.

In its 1987 report, the GAO recommended that the private sector should be given time to develop systems that would provide market participants increased access to Government securities pricing information. In its followup report issued in September 1990, the GAO recommended that Congress legislatively mandate that the Government securities price and price volume information be made available on a real time basis to anyone willing to pay the appropriate fees and that Treasury be assigned authority to prescribe regulations as needed to ensure that such transaction information is available. We fully support these recommendations.

We believe the need for Federal regulation is appropriate as there has been no significant increase in the dissemination of Government securities price information over the last 4 years. However, two private sector initiatives, GOVPX and EJV Partners, have been in development for several months and are now nearing implementation hold promise for expanded access.

Treasury fully supports the efforts undertaken by private sector initiatives, such as GOVPX and EJV in developing systems to disseminate Government securities price and volume information. However, we believe that the development of these two systems was significantly influenced by regulatory demand for improved public access and the growing pressure for a Federal regulatory presence in this area.

I think it is in the best interest of the market if private sector initiatives develop systems to disseminate Government securities price information. We also believe Federal rulemaking authority should be granted as a backstop to ensure that any private sector information dissemination systems are adequate, fair, and reasonable, although it may not be necessary to use this authority.

In summary, among the reasons for Treasury's designation as the rulemaker in 1986 was to provide for effective coordination among the interested Federal agencies. Coordination is becoming evermore critical in light of the exciting pace of innovation and growth in the Government securities market.

Treasury has used this unique position to assure that regulations governing the market were written and applied in an evenhanded way to both bank and nonbank broker-dealers. The need to rely on Treasury's position, perspective, and broad expertise in the market has not diminished. Rather, strengthening the Treasury's regulatory role will become increasingly vital as the legal and operational barriers separating the businesses of the different Government securities market players become less significant, highlighting the need for balanced treatment for all market participants.

The legislation we have proposed will strengthen Treasury's ability to ensure that any regulations will not impair the safety, integrity, liquidity, and efficiency of the market while also being responsive to the need of strengthening customer protection.

Finally, in addition to these factors, Treasury is in the best position to act as the principal agency overseeing the Government securities market due to its interest in ensuring that any rules do not inadvertently damage the market and thus increase the Government's cost of borrowing or reduce investor confidence.

Thank you.

[The complete prepared statement of Robert R. Glauber follows:]

For Release Upon Delivery
Expected at 2:00 PM
June 12, 1991

STATEMENT OF THE HONORABLE
ROBERT R. GLAUBER
UNDER SECRETARY OF THE TREASURY
FOR FINANCE
BEFORE THE
SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
JUNE 12, 1991

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before this Subcommittee to discuss the reauthorization of Treasury's rulemaking authority under the Government Securities Act of 1986 ("GSA" or "Act") as reflected in the legislation we have recently transmitted to the Congress entitled, "The Government Securities Act Amendments of 1991."

First, I will summarize Treasury's role in developing and implementing rules for the government securities market and the effectiveness of those rules in meeting the objectives set forth by Congress in enacting the GSA. Then I will discuss the legislation we have proposed that would: (1) extend Treasury's existing rulemaking authority; (2) grant Treasury additional rulemaking powers in the area of sales practices; (3) lift the restriction that currently precludes the National Association of Securities Dealers (NASD) from adopting government securities sales practice rules for its members; (4) grant Treasury discretionary authority to prescribe rules to ensure disclosure of and access to government securities price and volume information; and (5) make technical and conforming changes to the Securities Exchange Act of 1934.

DEVELOPING RULES TO ENSURE FAIR AND EFFICIENT MARKETS

The GSA established, for the first time, a federal system for the regulation of the entire government securities market, including previously unregulated brokers and dealers, in order to protect investors and to ensure the maintenance of a fair, honest, and liquid market. The GSA also assigned Treasury authority for developing and implementing rules pertaining to financial responsibility, protection of customer securities and funds, recordkeeping, reporting and auditing with respect to transactions in government securities conducted by government securities brokers and dealers (i.e., securities firms as well as financial institutions). The Act also called for Treasury to issue regulations relating to the custody of government securities held by depository institutions that are not government securities brokers or dealers. It was the expectation of Congress that Treasury would design rules to prevent fraudulent and manipulative acts and practices, to protect the integrity, liquidity, and efficiency of the government securities market, and to protect the public interest. At the same time, the rules were expected to preclude unfair discrimination between brokers, dealers, and customers, and avoid imposing any unnecessary burden on competition.

Treasury issued the final implementing regulations on July 24, 1987, in compliance with the requirements of the Act. In developing the regulations, Treasury consulted extensively with the Securities and Exchange Commission (SEC), the Board of Governors of the Federal Reserve System (Federal Reserve Board), the other regulatory agencies, and government securities market participants. This consultation and coordination throughout the rulemaking process provided an effective means for the affected entities to raise issues and to express their views concerning various provisions of the regulations.

In order to prevent excessive and duplicative regulation and to minimize compliance burdens, the GSA rules, for the most part, incorporated existing rules of the SEC and bank regulatory agencies. Treasury did, however, adopt a different capital rule for specialized government securities brokers and dealers (which were not registered prior to the GSA) and new rules for hold-in-custody repurchase transactions. As a result, the regulations imposed as few new requirements as possible on those government securities brokers and dealers that were already registered with the SEC as generalist firms or on financial institution broker-dealers that were subject to bank regulatory agency rules. Thus, the GSA regulations had the most significant effect on those entities that, prior to the enactment of the GSA, were not subject to any program of federal registration and regulation.

We believe the final GSA rules reflected a deliberate and responsive approach to regulating the government securities market, with due regard to striking the proper balance between strengthening customer protection (e.g., hold-in-custody repurchase transaction rules and financial responsibility standards) and ensuring the continued liquidity and efficiency of the market. The regulatory agencies, the General Accounting Office , market participants, and industry representatives all agree that Treasury has done a good job of regulating the government securities market.

In part, the GSA was a response to abusive practices by several firms in the repurchase transaction market. These abuses resulted in large customer losses when the firms failed. As a result, one specific area that Congress targeted was the strengthening of customer protection in hold-in-custody repurchase transactions. Due to the several requirements imposed by Treasury's rules -- written repurchase agreements must be in place, certain risks of the transaction must be disclosed to the customer, specific securities must be allocated to and segregated for the customer, and confirmations must be issued -- we believe, as do many market participants, the various regulatory agencies and the GAO, that there now exists a greater degree of customer protection in the repurchase agreement market.

Enforcement of the GSA regulations and supervision of the government securities brokers and dealers by the federal regulatory agencies and self-regulatory organizations has varied. We believe that regular and frequent examinations and timely dissemination of information by the regulatory agencies to the institutions they supervise are essential to ensure that the goals of the GSA are being met. Overall, based on examinations of the government securities brokers and dealers conducted by the regulatory agencies and self-regulatory organizations, the level of compliance with the GSA regulations is satisfactory. Although the agencies have reported violations of the regulations by some institutions, most of the instances of noncompliance were easily correctable and stemmed from misunderstandings of the new rules.

We believe that the actions taken by Treasury, the federal regulatory agencies and the self-regulatory organizations in implementing the GSA regulations have successfully met the objectives established by Congress in enacting the GSA. The rules have been timely and fairly implemented and have improved and strengthened investor safety in the market. At the same time, the rules have not imposed excessive and overly burdensome requirements and have not impaired the liquidity, efficiency and integrity of the government securities market. Most importantly, no customers have lost any funds or securities in those instances where government securities brokers or dealers have failed or discontinued business since the inception of the GSA regulations.

EXTENSION OF TREASURY'S RULEMAKING AUTHORITY

In enacting the GSA, Congress imposed an October 1, 1991, sunset on Treasury's rulemaking authority over the government securities market. Without an extension, Treasury's prospective rulemaking and exemptive authority will cease. We believe that Treasury's continued regulatory presence in the market is required.

In its deliberations on the GSA, Congress recognized the importance of maintaining the liquidity and efficiency of the government securities market. In addition, any regulatory activity must be balanced with its impact on both the market and the cost of Treasury borrowings. As I have just recounted, Treasury's rulemaking has been effective in achieving the purposes of the GSA.

The implementation and administration of the GSA has strengthened investor protection and heightened investor confidence without significant adverse impact on the government securities market and its participants. Much of this result can be attributed to the on-going and effective consultation and coordination among Treasury, the SEC, the Federal Reserve Board, and the various other enforcement and self-regulatory entities. Continued effectiveness in regulating the government securities market requires a continuation of these relationships.

Because the government securities market encompasses the activities of both registered brokers and dealers and financial institutions, a single rulemaker must be empowered to ensure that appropriate government securities regulations are in place for all market participants.

Treasury is in the best position to act as the federal agency overseeing the government securities market because Treasury has a comprehensive understanding of the market and, as issuer, is concerned with maintaining market integrity and efficiency. Market efficiency and integrity benefit the public by minimizing the cost of government borrowing. In addition, Treasury as the single rulemaker can assure that appropriate regulations are in place for all market participants. These factors enhance Treasury's ability to coordinate the views of the various entities and to ensure that the interests of all parties are considered. Treasury's role as rulemaker provides balanced regulatory treatment among the various market participants, and provides the necessary knowledge and expertise to address possible changes in the structure of the dynamic government securities market.

Accordingly, we recommend that Congress extend Treasury's rulemaking authority by enacting the legislation we have proposed that would delete the sunset provision contained in the GSA. The extension of Treasury's authority is supported by the SEC and the Federal Reserve Board -- as recommended in the joint report with Treasury that was submitted to Congress in October 1990 -- and the GAO in its September 1990 report to Congress. In addition, the NASD, the New York Stock Exchange, the Public Securities Association, the American Bankers Association, and all of the bank regulatory agencies support the extension of Treasury's authority.

SALES PRACTICE RULES

Sales practice rules govern a broker-dealer's business relationship with its customers. Such rules are generally intended to ensure, among other things, that broker-dealers conduct fair dealings with customers, that the securities purchased are suitable investments, and that transactions are priced fairly and reasonably. The scope of the GSA and the regulatory authority granted thereunder were limited to those areas of documented abuse and weakness in the government securities market (e.g., unregistered firms, hold-in-custody repurchase transactions), because of the concern that excessive regulation would impair the efficient operation of the market.

Consequently, the GSA did not grant Treasury the authority to prescribe sales practice rules pertaining to transactions in government securities. Additionally, the GSA continued the restriction placed on the NASD that prohibits it from applying its sales practice rules to the government securities transactions conducted by its members. The GSA did, however, authorize the NASD to write rules prohibiting fraudulent, misleading, deceptive or false advertising in connection with the sale of government securities. It should be noted that the registered securities exchanges are permitted to apply their sales practice rules to their members' government securities transactions.

Need for Sales Practice Rules

It is difficult to assess the magnitude and severity of the problem given the lack of specific evidence of widespread sales practice abuses. Indeed, some of the well publicized cases involving customer losses in government securities transactions may not have stemmed solely from abusive sales practices. Nevertheless, the fact is that the government securities market is the only regulated securities market in the United States that does not have broadly applicable sales practice rules. Such rules have become a fixture in all of the securities markets in the United States but, currently, such rules are not imposed for the vast majority of transactions in government securities. The same kinds of abuses that made sales practice rules necessary in the corporate, municipal and penny stock markets may well occur in the government securities market. By applying sales practice rules to the government securities market, investors would benefit from protection similar to those afforded them in other markets. The Treasury clearly wants to prevent unscrupulous brokers and dealers, who may have operated in these other markets until the advent of sales practice rules in those arenas, from gravitating to the government securities market.

The government securities market remains principally a wholesale market in which brokers, dealers, large commercial banks and experienced institutional investors have sufficient knowledge and bargaining power to reduce or eliminate the need for protection afforded by sales practice rules. It is also true that a significant number of smaller and less experienced investors also participate in this market. Our area of concern is not the large, institutional investors, who should be expected to have the knowledge to judge the suitability of particular securities, but the smaller, less sophisticated customers who are attracted to participating in the government market because of their desire for safe and secure investments. Additionally, the government securities market increasingly encompasses instruments that can pose greater risk of adverse price movements than traditional investments in Treasury or agency securities. These instruments include mortgage-backed securities, including collateralized mortgage obligations issued or guaranteed by Government agencies; zero-coupon securities such as STRIPS and agency IOs and POs; and over-the-counter options. Some of these products are quite similar to registered securities that are already subject to sales practice rules or that trade in combination strategies with instruments that are covered by such rules. Even though many of these securities are backed by a U.S. government guarantee and are attractive due to their higher returns, unsophisticated investors may not fully understand their complexity, risks and speculative nature. Further, some of these securities do not have readily available pricing information to enable customers to independently determine their market value.

The SEC has authority under section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) to promulgate and enforce rules prohibiting fraudulent, manipulative, and deceptive acts and practices. However, the adoption of sales practice rules for the government market would enable the regulatory agencies to take disciplinary actions without having to prove intent by the broker-dealer to defraud a customer. Currently, sales practice abuses in most of the government market must be so egregious as to rise to the level of fraud before any action can be taken.

Treasury Legislative Proposal for Sales Practice Rules

For these reasons, we urge Congress to adopt Treasury's regulatory proposal for government securities sales practice rules. The proposal would:

1. Grant Treasury the authority to prescribe government securities sales practice rules reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices for all government securities brokers and dealers;

2. Grant Treasury the authority to adopt sales practice rules reasonably designed to promote just and equitable principles of trade for financial institutions that have filed notice as government securities brokers or dealers; and

3. Authorize the NASD to adopt government securities sales practice rules for its members, subject to approval by the

SEC in consultation with Treasury. Any NASD rules must be consistent with Treasury sales practice rules.

Granting Treasury rulemaking authority for sales practices pertaining to transactions in government securities would be consistent with the regulatory structure set out in the GSA. Treasury was selected as the sole rulemaker due to its expertise in the market, its interest in balancing customer protection with the need to preserve the efficiency and liquidity of the market, and its ability to provide balanced regulatory treatment among the various market participants. This regulatory approach would continue to recognize Treasury's knowledge of the market and its responsibility, as the largest issuer, to ensure that any sales practice rules, while strengthening customer protection, would not impair the liquidity or efficiency of the market or increase the cost of financing the public debt.

Regarding any potential concern that granting Treasury rulemaking authority over sales practices would raise a conflict of interest given our role as issuer, this issue was addressed by the Senate Banking Committee during its deliberations on the GSA in 1986. The Committee satisfied itself that there would be no conflict of interest and expressed its confidence that Treasury would "... fully and faithfully pursue the rulemaking authority granted ..." Further, we believe our actions as GSA rulemaker over the past four years should resolve any such concerns. Treasury has demonstrated its commitment to effective regulation of the government securities market by issuing balanced and fair rules that do not unfairly discriminate among market participants and, more importantly, that do not advantage Treasury securities over other government securities.

We believe sales practice rules must apply to all government securities broker-dealers -- both bank and non-bank broker-dealers -- to ensure a level playing field for all market participants. This is consistent with the GSA mandate that any rules should be designed in such a manner that does not permit unfair discrimination between government securities brokers and dealers or customers. Accordingly, vesting rulemaking authority with Treasury would ensure that sales practice rules would provide comparable protection to customers of both bank and non-bank broker-dealers.

We also urge that Congress rescind the current restriction on the NASD's authority regarding sales practice rules. Such action would be consistent with the Congress' prior decision to use the expertise of self-regulatory organizations. The legislative history preceding the Securities Acts Amendments of 1975, in reaffirming the system of self-regulation, cited as an advantage of self-regulation, "the expertise and intimate familiarity with complex securities operations which members of the industry can bring to bear on regulatory problems, and the informality and flexibility of self-regulatory procedures."

Lifting the NASD restriction would put to use its expertise and experience in implementing sales practice rules it has developed for other markets. It would also capitalize on the NASD's knowledge of the business practices of its members, its ability to provide for inter-market comparability, its flexibility in updating its rules to stay abreast of market developments, and its role as a member of the securities industry.

Approach to Sales Practice Rules

Although it is too early to know the precise parameters of any sales practices rules, three areas that may require attention are excessive mark-ups, suitability of recommendations to customers, and unauthorized trading. In developing sales practice rules, we will consider whether different standards are needed based on the complexity and risks of the various securities and whether distinctions need to be made based on the type of customer (i.e., institutional or sophisticated versus retail or individual) involved in the transaction. As has been our practice, we will attempt to model our rules upon existing rules of the SEC, NASD, New York Stock Exchange and Municipal Securities Rulemaking Board (MSRB), where appropriate. Finally, Treasury will consult with the industry, the regulatory agencies and the self-regulatory organizations during the development of the rules.

Strengthening Market Integrity and Investor Confidence

We believe that the extension of sales practice rules to the government securities market will strengthen investor confidence and integrity in the market and will significantly enhance customer protection. Sales practice rules should not result in excessive burdens or significantly increase costs because diversified firms already must comply with sales practice rules for their corporate and municipal securities activities and banks that conduct a business in municipal securities must comply with MSRB sales practice rules. Any rules proposed by Treasury would be designed so that the benefits in terms of customer protection will outweigh any increased regulatory costs or burdens, which we believe would be minimal, in any event.

ACCESS TO GOVERNMENT SECURITIES PRICE AND VOLUME INFORMATION

Public Interest Benefits

Treasury supports expanded disclosure of and access to government securities price and volume information. Expanded information access would serve to enhance customer protection, since customers would be in a better position to determine actual or potential transaction prices for securities, especially for inactively traded issues, and to evaluate the fairness of trades being proposed by a broker or dealer. Moreover, we believe the expanded availability of such information would serve the public interest because it would ensure that a broad spectrum of market participants could obtain current, accurate facts related to market conditions, and thus, the competitiveness, liquidity and efficiency of the government securities market would improve.

Greater access to price and volume information will also foster increased competition between dealers since market quotes will be more widely disseminated. Improvements in the derivative markets are also likely to accrue due to the availability of more timely and accurate information on the underlying securities used for pricing and hedging strategies. Further, access to more accurate price information will enhance the ability of regulatory examiners and independent auditors to carry our their respective responsibilities to ensure that securities transactions and positions are valued appropriately.

Industry Efforts

The need for increased access to government securities price and volume information has been a topic of discussion for a number of years. In its 1987 report, the GAO recommended that market participants be provided increased access to government securities pricing information. At that time, the GAO did not support a federal regulatory structure to achieve expanded access because it believed private sector initiatives, which could obviate the need for such action, should be allowed time to develop price disclosure systems.

In its follow-up report issued in September 1990, the GAO recommended that Congress legislatively mandate that government securities transaction information be made available on a real-time basis to anyone willing to pay the appropriate fees. GAO further recommended that regulatory authority be assigned to Treasury to prescribe regulations as needed to ensure that such transaction information is available. We fully support the recommendation to grant Treasury this rulemaking authority.

We believe the need for federal regulation is appropriate given that there has been no significant increase in the dissemination of government securities price information over the last four years. This is highlighted by the number of unsuccessful attempts by various market participants to develop price disclosure systems. However, two private sector initiatives, that have been in development for several months and are nearing implementation, hold promise for expanded access.

One initiative, an industry-wide joint venture known as GOVPX, Inc., will disseminate real-time price and quotation information on all Treasury bills, notes and bonds on a 24-hour, global basis. This information will be provided to on-line vendors for redistribution to the public. GOVPX is scheduled to be operational on June 16. A second initiative involves Electronic Joint Venture Partners (EJV) which plans to introduce a new computerized trading system where broker-dealers will arrange their purchases and sales electronically. EJV will also deliver real-time market information to the financial services industry.

Federal Regulatory Structure Still Needed

Treasury fully supports the efforts undertaken by private sector initiatives such as GOVPX and EJV in developing systems to disseminate government securities price and volume information. However, we believe that the development of these two systems was significantly influenced by regulatory demands for improved public access and the growing pressure for a federal regulatory presence in this area. We also believe federal rulemaking authority should be granted, as a backstop, to ensure that any private sector information dissemination systems are adequate, fair and reasonable, although it may not be necessary to use this authority.

An example of the potential use of rulemaking authority would be to ensure that information disclosure systems, such as GOVPX, collect and distribute price and volume information on mortgage-backed securities and zero-coupon securities, in addition to Treasury bills, notes and bonds. Another example would be to ensure that such systems provide the best offer for a security rather than the offer accompanying the best bid (as provided by GOVPX) since the best offer affords market participants a more accurate reflection of market prices.

Treasury Legislative Proposal

To provide the public with the benefits of expanded access, we urge Congress to grant Treasury discretionary authority, similar to the existing authority of the SEC with respect to non-exempt securities transaction information, to regulate disclosure of and access to government securities price and volume information. We believe it is in the best interest of the market if private sector initiatives develop systems to disseminate government securities price information. However, given their past record, discretionary rulemaking authority vested at Treasury is necessary in the event these efforts are not successful or do not provide adequate information. The GAO has also recommended that Treasury be the rulemaker for information access.

Given our expertise in the government securities market, Treasury is in the best position to evaluate the reasonableness and sufficiency of information disclosure systems and their effect on competition and safety of the market, and to prescribe rules, if necessary, to ensure that price dissemination arrangements are fair and beneficial to the operation of the government securities market and its participants.

TECHNICAL AND CONFORMING AMENDMENTS

Treasury's proposed legislation also contains several technical and conforming amendments to the Exchange Act which we urge the Congress to adopt. Two amendments revise the definition of the term "appropriate regulatory agency." These changes are intended to make supervisory responsibilities under the GSA consistent with existing bank regulatory agency supervisory responsibilities regarding certain financial institutions that are government securities brokers or dealers. Two conforming amendments respond to changes in nomenclature under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Another amendment involves adding to the Exchange Act a new definition for the term "government securities information processor." The final technical amendment clarifies an information sharing provision in the GSA.

CONCLUSION

Among the reasons Treasury was designated as the rulemaker in 1986 was the need for effective coordination among the interested federal agencies. This coordination is becoming ever more critical in light of the accelerating pace of innovation and growth in the government securities market.

The Treasury has used this unique position to assure that regulations governing the market were written and applied in an even-handed way to both bank and non-bank broker-dealers. The need to rely on Treasury's position, perspective and broad expertise in the market has not diminished. Rather, strengthening Treasury's regulatory role will become increasingly vital as the legal and operational barriers separating the businesses of the different government securities market players become less significant, highlighting the need for balanced treatment for all market participants.

The legislation we have proposed will strengthen Treasury's ability to ensure that any regulations will not impair the safety, integrity, liquidity, and efficiency of the market while also being responsive to the need of strengthening customer protection. Finally, in addition to these factors, Treasury is in the best position to act as the principal agency overseeing the government securities market due to its interest in ensuring that any rules do not inadvertently damage the market, thus increasing the government's cost of borrowing or reducing investor confidence.

Senator **Dodd**. Thank you all very, very much, for your testimony. And let me address some questions to you and I will address them specifically to individuals but I don't want any of you to feel restrained from commenting on any of these questions as we move along.

Under Secretary Glauber, on page 10 of your testimony, you state that while the Treasury fully supports the private sector initiatives such as GOVPX, that you believe, and I quote, "that the Federal rulemaking authority should be granted as a backstop."

You reiterated that statement in your testimony just a moment ago.

As I read the legislation that has been submitted by Treasury, Treasury's authority would be rather broad in this area, and discretionary, to put it mildly. There is no requirement that Treasury wait to see how the private sector system would work. That's not what I would call a backstop, given the broadness.

Mr. **Glauber**. Well, our intention is that it be a backstop. We do not want to overregulate this market.

I just would emphasize to you, Mr. Chairman, that it is our sense that, without prodding, these information providers would have not have come forward and that these systems, one of which is about to go into operation, might well not have happened. I think it was the pressure——

Senator **Dodd**. I'm sorry. I didn't hear the last thing you said.

Mr. **Glauber**. It is our concern that without pressure from the GAO and interest in the possibility of regulatory legislation that these systems might not have come forward.

Senator **Dodd**. Well, you're anticipating—do you want to go on further?

Mr. **Glauber**. No, I'm happy to stop.

Senator **Dodd**. The first rule is don't say too much.

Mr. **Glauber**. As they say, when you've made the sale shut up. But I don't think I've made the sale.

Senator **Dodd**. Well, I will ask both Chairman Breeden and Mr. LaWare to comment as well. Let me ask, is it your contention here that in the case of GOVPX, that wouldn't have happened in the absence of the threat of legislation?

Mr. **Breeden**. Mr. Chairman, I don't know the answer to whether it would have happened without the threat of legislation. I'm not sure that it's relevant. What's relevant is that it did happen. The system is going into effect.

So the question for the future is not what did it take to get them this far, but what should we do to make sure that the progress to date continues at the best possible speed and that we don't do anything now that has the effect of inhibiting the development of the systems just as we're on the doorstep.

It may well have been the threat of regulation that caused them to be serious about developing GOVPX, but they now have it, and I don't know whether the reward for developing it needs to be to hit them over the head with an extensive new regulatory program.

My sense would be that first we ought to find out if it works. If it does, if it can operate and provide the information and it does so reliably, then that's all we need. It's a very great difference as to whether you have a system that works sporadically or works continuously, whether it has the kinds of backup systems that are necessary, whether the security is good, whether the prices quoted are reliable. There are a whole host of criteria relative to any of these electronic systems—and we oversee about a dozen of them to make sure that they're working correctly.

The first step ought to be to find out if it works.

Mr. LAWARE. We are substantially in agreement with Chairman Breeden on this point, sir.

Senator DODD. I don't disagree that one of the reasons—whether it was the GAO or Treasury moving or their knowing we're going to reauthorize, the chat around town—and perhaps the industry says we'd better get our backsides in gear here and do something. I never complain terribly about why people do something. In a sense here, that's a good argument on why we shouldn't let this be given a chance to work. Then, if it doesn't, Lord knows we can legislate pretty quickly around here when we want to.

Mr. GLAUBER. Certainly, that would be an approach. And certainly I think we ought to let this system evolve and see whether it works. I quite agree with Chairman Breeden on that.

We are—again, let me emphasize, what we envision and have requested is backup authority and your characterization of what we asked for as being quite broad, I think, is fair and we would not be opposed to limitations on it. Whether you would want to go as far as to not grant this authority and then wait and see is a decision Congress is going to have to make. But certainly if you grant it and grant it with some limitations upon it, we wouldn't be opposed to that.

Senator DODD. The concern I have about that particular aspect is that when you—the tendency around town here is when you grant authority it gets used. I mean, isn't that sort of your experience as well?

Mr. GLAUBER. I would not argue with that.

On the other hand, let me emphasize two things. One is that there are still things that need to be done in the provision of information. Even when it comes on stream, GOVPX will only cover Treasurys, it will not cover CMO's and agency securities. So there still is a good deal of development to be done. There obviously are issues of fair access and these sorts of things too. So we shouldn't act as though it's all been done.

I also agree with you that we don't want to regulate where it is not necessary.

Senator DODD. Chairman Breeden has made a recommendation that is somewhat similar to what is being suggested that would grant authority now only to be used in the future if certain findings are made at the time the private sectors fail. How does that appeal to you?

Mr. GLAUBER. I think that that's a sensible approach.

Senator DODD. Now, Chairman Breeden, what's the difference between doing what you're suggesting and in giving a chance for the private sector system to work? Why do we even need do what you're suggesting?

Mr. BREEDEN. Well, I'm not wedded to having the backstop authority. We had thought that it would be most useful to the private system development to have in essence no more than monitoring of what's happening and review of how the system works. If there are glitches, if market participants have complaints, there should be somebody that is charged with being able to come back and tell Congress whether or not the system is working. That's the limit of what I envisioned and what we were suggesting—somebody who has the responsibility. As you suggested, Mr. Chairman, you can legislate if the system isn't working. Who is it that's going to evaluate whether it's working and going to come back and tell you that?

Since we already have many people who spend all day long everyday monitoring electronic systems and how they work, I had thought it would be most simple—to avoid having to go hire and staff a new bureaucracy to perform that function—to ask the existing mechanism to be used for the purposes for which it was created.

Senator **Dodd**. You're sort of anticipating my next line of questions to ask the three of you here, too, as we move to the question of rulemaking authority. And, again, perhaps we're being a bit facetious on these turf questions. But I think you will appreciate our job is so much more difficult when we try and sort out where the administration is on some of these matters.

I realize that there are differences. One might argue that it's refreshing in a way, that we get good discussion and differences of opinion. I don't want to have my statements to suggest that we want to go back to the days where people came up and we all knew that someone had an entirely different view than what they were willing to testify to publicly.

That I found far more onerous and difficult to deal with than the good honest candor when people come forward and say, look, we're part of the same team. We disagree about some things. So I don't want you to misinterpret the comments here about that particular point.

But I think you understand what's behind those comments.

It's always much easier if everyone is singing out of the same hymn book when possible.

Let me ask you, Secretary Glauber, if I can, and then Governor LaWare, about the point Chairman Breeden has made about the SEC. Frankly, it sounds fairly reasonable. I don't say that here as the chairman of the Subcommittee on the Securities Industry, but I must tell you his comments strike me as being fairly reasonable, about why it makes more sense to give the SEC, and not the Treasury, rulemaking authority in the area of price dissemination and the primary oversight role for sales practice rules, which would be written, I gather, by NASD.

You say in your testimony, that the NASD can write them but they've got to be consistent with Treasury rules, which would sort of indicate the Treasury would write them first and then the NASD would write them.

And yet there is a background here. There is an experience, there is personnel, there is some history here. It seems to me, if you kind of got that in place somewhere in the Government, you try and tap into it.

But tell me why you think that's wrong?

Mr. **Glauber**. Well, back in 1986, Congress made a decision to give Treasury rulemaking authority for the Government securities market. It did so, I believe, because it thought Treasury had expertise in this market. It was its particular market. And therefore, it made sense to give Treasury those responsibilities. And, indeed, all of us are coming before you today to recommend the extension of those authorities.

When we moved to sales practices, I suppose the question you have to ask is, does the expertise in the Government securities market weigh more heavily in determining to whom you should give this, or expertise in general sales practice rulemaking. And that's a judgment you obviously have to make.

The proposal we brought before you is one in which the rules for broker-dealers that are members of the NASD would be made by the NASD overseen by the SEC with a provision that there would be consultation to assure consistency with the rules the Treasury, as the overall rulemaker, would set for non-NASD overseen institutions.

We think there is merit in that because we think that Treasury then can be in a position to assure a balanced treatment of all participants so there is a level playing field among all participants in the Government securities market. And that's the basis for our recommendation.

Senator DODD. Mr. LaWare, do you want to comment on this?

Mr. LAWARE. Our position, I think, is fairly clearly laid out in the statement that we don't feel an overwhelming need for sales practice rules.

Senator DODD. I understand that.

Mr. LAWARE. We don't think that there's any indication of abuses among the bank dealers.

Senator DODD. Right.

Mr. LAWARE. And that if, in fact, a need exists with the nonbank dealers, that the NASD solution is a convenient one and would involve the least disruption and conflict.

Senator DODD. Do you want to comment on this?

Mr. BREEDEN. Well, I would concur with Bob's characterization of the issue. We think it is entirely appropriate that Treasury and solely the Treasury ought to set the rules regarding the conduct of auctions for selling securities—Treasury securities—and that they ought to be responsible for the recordkeeping and other responsibilities that they now have as the issuer and as the representative of the taxpayer. Their job is to issue these securities at the lowest possible cost. And that should be their job.

Now the question comes, you've got after-market trading going on. And you have a registered rep who is on the phone. He calls up the customer and he says, let's talk about your account. The customer asks, well, what are AT&T bonds yielding? And the conversation swings to what might be available in State of Connecticut bonds. And the next question is, well, how about Treasurys? What are they yielding? Or Freddie Macs and Fannie Maes. And that is a conversation going on over the telephone between a broker and a customer. And it would be, I think, rather cumbersome, rather complex, and you would have the risk of confusion for both customers and the brokers, if each time a different instrument is discussed, you have to take a new rule book down off the shelf and do a quick turn to the page and find out what the Treasury says you can say over the telephone about suitability standards or churning or markups. And if it changes to a municipal security, put that back and find out what the SEC and the MSRB say. And if it's a non-Government security, find out about the NASD.

We have a system. It needs removal of a loophole in which existing rules covering existing members do not get applied to some few instruments. Remove that disability, if you will, on the NASD's from applying its normal rules, and I think you've solved the problem.

The notion that we have to go beyond that and say that we need a whole additional Code of Federal Regulations that will essentially preveto anything the NASD does is—I haven't seen a case for it in terms of abuse in the marketplace. The SEC already regulates more than 80 percent of the participants in the market, about 85 percent of the intermediaries. So why do we need to suddenly take a system that works perfectly well and has 60 years of experience and re-create it somewhere else is—I haven't seen the case for it.

Mr. GLAUBER. I'm not sure that we're proposing re-creating it somewhere else. We certainly propose giving the NASD the authority to set these rules subject to the SEC's oversight. We do believe that rules should be set for financial institutions as well, to provide an even, level playing field. With that, I think we may disagree with Governor LaWare. But what we do say is that there should be consultation to assure that there is consistency in the rules set so that you don't have a situation where there are different rules for broker-dealers covered by the NASD and for financial institutions that are not.

I don't think that the differences are as great as might appear to the eye.

Senator DODD. As a practical matter, what Chairman Breeden was describing as a real live situation, is that realistic?

Mr. GLAUBER. I don't think that we would end up there at all. The NASD would prescribe the rules subject to the SEC's oversight. What we would ask for is consultation to assure consistency. That's what we're talking about.

Senator DODD. So the practical matter of a dealer sitting there and pulling different books down off a shelf, is it unrealistic?

Mr. GLAUBER. I think he just has to pull down the NASD book, which would have a section in it on Government securities.

Mr. BREEDEN. Now we have two different books—two different sections.

I'd like to emphasize we agree totally that, to the degree that the Treasury is suggesting that the NASD rules should be allowed to apply in this area, that's our belief of how to solve the problem. We'd be happy to stop there.

And in that respect we agree, I think, totally with the Federal Reserve that that solves the real problem in the marketplace. We have not seen a pattern of serious misbehavior among the banks and think that the current system as to the banks is probably adequate.

To the degree that Congress feels it necessary to go beyond letting the NASD rules apply to most of the participants in the market, then we would suggest that to avoid the situation that there is one set of NASD rules for AT&T bonds and a slightly separate section in the book, back in the back, that maybe the broker's got to either learn two sections or maybe if he remembers one and not the other, we don't need to create that risk. There ought to be one system for reviewing those rules, and that that clearly ought to involve active consultation with the Treasury. I agree also with Bob on that.

We don't believe that the Treasury needs to have the veto powers that their legislation calls for, that is being able to set prescriptive rules that would control anything else the NASD might want to do, because the system of self-regulation that the New York Stock Exchange and the NASD represent has almost six decades of experience in this country. It works very, very well because you have people who are in the market every day and who understand what churning is and what kinds of improper overreaching can occur between brokers and customers, and you have the people there on the front lines making sure that they keep their own business clean.

That system has worked very, very well and I just haven't seen a case for overriding it on some standby or other basis. What we ought to do is let it operate. If it proves unacceptable, if it proves unable to control problems, let's come back then.

Senator **Dodd**. Let me move to the issue of whether or not we need to have any new authority at all. Let me start with you, Secretary Glauber.

On page 3 of your testimony, you—and I think rightly so—compliment the Treasury and other agencies on the effectiveness of implementing the Government Securities Act of 1986. You state, and I quote, "Most importantly, no customers have lost any funds or securities in those instances where Government securities brokers or dealers have failed or discontinued business since the inception of the GSA regulations."

In short, it's worked well, been effective.

On page 5, you go on to say that the regulatory authority under the original 1986 act was "limited to those areas of documented abuse and weaknesses in the market."

Then later on you talk about recent publicized cases involving customer losses and Government securities and you say these, and I quote, "may not have stemmed solely from abusive sales practices."

Now we have heard already both the Fed and the SEC say that they believe the case has not been made for new sales practices rules. It just hasn't been laid out. We may hear testimony later that will indicate otherwise, but at least for the purposes of this panel in discussion, that seems to be the trend.

I have several questions for you. One is, has a case been made, in your view. Have there been documented abuses? Or are you just suggesting, the potential for abuse is there and, therefore, the new authority is needed. Not for what's out there, but for what may be out there as a result of the changing environment.

Mr. **Glauber**. There have been some abuses. As we say, it's unclear that they arise primarily from sales practices abuses. There have been, even recently, some evidence. The RTC report on financial institutions traces abuses in the Government securities market as the reason for some of the losses in the institutions they have looked at.

But I will agree with you that the information collection system isn't very good and therefore the evidence isn't very extensive.

The problem is this, and the reason we think that it—and I gather GAO thinks as well—that it's time to do this is that we have less sophisticated investors dealing in this—market. The securities have become more complex. Even though the securities themselves, the underlying risk isn't there because they are Government guaranteed, nevertheless the securities have become so complicated that the opportunities for loss and unsuitability for investors has increased.

So I think that there is a good presumption that we need to do something. Furthermore, it is now the only regulated market in which we don't have sales practice rules.

As my friend, Chairman Breeden, is successful in driving the miscreants out of the penny stock market, they have—they presumably look for a place to go. They're running out of places to go. This is one of the places, one of the last places they can go. And I think we ought to be concerned about it.

Senator DODD. I don't disagree with being concerned about it and you make a good point.

But I am a little uneasy—maybe it is that we don't have an ability to document it fully enough. How about that, Mr. LaWare?

Mr. LAWARE. Well, we've said a couple of times here that we don't think we've got a serious enough situation to figure this. And I guess I'm convinced that one of the crown jewels of our economy is the effectiveness and efficiency of our capital markets. They are the best in the world.

And I am absolutely convinced that overregulation of these markets can destroy that efficiency. Consequently, we are very much in favor of moving where there is a crisis, where there is a problem, but until we can demonstrate that a problem exists, we would caution to hold back.

Senator DODD. And, Richard, you feel very much the same?

Mr. BREEDEN. I want to agree with Bob and strongly subscribe to his concerns about potential problems. This is a market, however, and we would agree with the Federal Reserve where there is not currently the level of abuse that makes it necessary to have a large, new regulatory program.

We are sensitive to the kinds of concerns that Bob Glauber has discussed. We would not want to see that situation change. Therefore, we strongly support letting the NASD apply its rules. And in this whole sales practice area, we're talking about churning, we're talking about cold calls, we're talking about markups, we're talking about suitability, we're talking about unauthorized trades, and to some degree we're talking about adjusting trades. But that's what we're debating about.

The NASD has rules on all those subjects. We ought to let them apply them the same way they apply the same rules to trades in AT&T bonds or other instruments. I think that step would be sufficient to deal with this potential problem. It's not a problem that now exists, but it's a problem that could exist. And we shouldn't take that risk.

But I think we can stop there. I don't think personally that we need to go beyond that and say, in addition Treasury or the Commerce Department or somebody else can sit and write a whole new code of rules on top of what the NASD has done, all to reinvent the wheel, to solve a problem that doesn't yet exist that we fear might someday exist.

Senator Dodd. Well, that's very, very helpful. And I appreciate your willingness to sort of engage one another here on various points, and they're good points. You're both in a sense urging caution in different ways and we'll just have to give it some thought.

Let me ask you all one last question if I can, and I'm appreciative of the time you've spent up here. I want to raise the question about the squeeze in the 2-year Treasury notes, the reports—I know—not Bob, you're not answering this question. You're going to stay and answer the question, I see.

Mr. Glauber. I do what I'm told.

Senator Dodd. Obviously you all saw the reports that a rather significant portion of the recent $12 billion issues on 2-year Treasury notes ended up in the hands of a few owners who were demanding a premium for selling or lending the securities. Reports further indicated that there was a squeeze on dealers and investors who needed to acquire the 2-year notes in order to cover the short market position.

Now The Washington Post, among others, reported on May 31 that "carrying out such a squeeze would not normally be illegal." And that line particularly caught my eye and I'd like to inquire of all three of you whether or not that's the case. Is this illegal or not, No. 1. Second, what if any problems does this kind of a practice cause in the markets. And, third, what if anything are you doing about it that we should be aware of here on the Hill. Finally, do you have enough authority under current law to deal with the problem given some of the things you think ought to be done.

Who wants to be the first?

Mr. LaWare. The Treasury conducts about 160 auctions annually. While this particular experience—the extent of concentration here—was not typical, it was not that unusual. It was toward the high end of concentrations in a successful auction, but it was not an event that only happens every 5 years.

We don't understand all of what went on there, exactly, yet, but we have a pretty good idea that it was eventually unwound after some discussions were held, and I don't think that anyone involved in it was significantly damaged by it. And it was within the limits of what we will allow or what the Treasury will allow as the maximum percentage allotment to a successful bidder.

Senator Dodd. Nothing illegal here?

Mr. LaWare. I don't think so. We have not been able to discern anything illegal.

Senator Dodd. And you see no reason to take any action—under the existing authority that exists——

Mr. LaWare. We would not want this kind of concentration to be typical. But the fact that it happens on occasion does not create a threat to the orderly operation of the market.

Senator Dodd. Bob, do you want to comment on that any further?

Mr. **Glauber**. Not a great deal more. Our major responsibility here is, of course, auctioning the securities. In the aftermarket, whether there was fraud or not, is an issue, really, under 10(b) of the Securities Act and is an SEC issue or perhaps an antitrust issue, which is a Department of Justice issue.

As regards the auction, as you know we have a rule on the amount that an individual bidder can take down, 35 percent. And I think that that's a workable rule. I suppose there is the possibility that higher concentrations would exist because in some hypothetical situation two or more participants could act together, in which case we might want to think about modifications to the rule to take care of such a situation.

But that really is the extent of our direct concern about the issue.

Senator **Dodd**. And you're satisfied that whatever authority you have presently would allow you to handle that?

Mr. **Glauber**. At this time, yes.

Senator **Dodd**. Richard.

Mr. **Breeden**. I would first note that both our Divisions of Market Regulation and Enforcement have been in close consultation with the Treasury and the Federal Reserve about this. I think market participants should understand that there is a very high capability for surveillance in this area, as Bob suggested. There are some issues under section 10(b) of the Securities Exchange Act of 1934. Obviously, we wouldn't want to comment whether there was an ongoing investigation in this area or not. I would not want to state that it is unequivocally clear that there were no violations in the law. That would remain the subject of a detailed investigation. And irrespective of what we might know at this stage, I'm not prepared to make that statement.

That may be true as to violation of the auction rules. And there again, we leave totally to the Treasury the question of what kinds of rules they ought to have for the conduct of auctions and what the maximum blocks that any participant ought to take down. But for example, if there is a rule that no participant can take down 35 percent or more of a given issue, and three people miraculously take down 30 percent each, and are doing so—if the facts prove that they were doing so—in concert with a prearranged plan to conduct themselves in a certain way, I would not wish to agree in advance that that would necessarily be either consistent with the Treasury rules or consistent with section 10(b), and I would reserve the right that we would take action in an appropriate case where an investigation had provided the facts and evidence to warrant an action.

Senator **Dodd**. OK. Thank you for that.

But I would further ask you on that point, as you look at this, keep us currently posted as to what you're thinking in this area. I appreciate your candor in responding to that as well.

You have been very gracious. I am confident that Senator Gramm and perhaps others will maybe want to submit some questions in writing if they are not satisfied with the ground we've covered. If that's the case, I'd ask you to get back as soon as you can. We are on a fast clock here and we need to decide what to do pretty quickly, so I appreciate your willingness to be up here today and look forward to an ongoing discussion with you as we move forward with legislation.

Thank you for your participation. [Panel excused.]

Our second panel of witnesses.

We'll give our first panel and their staffs an opportunity to clear out of the room.

I'll ask our second panel to join us.

Robert V. Stout is the finance director for Ridgefield, CT. He is testifying on behalf of the Government Finance Officers Association. We want to welcome you, Mr. Stout, and I want the record to show that you're here not at my invitation, but rather selected by the Government Finance Officers Association. It is pure coincidence that someone from my home State would be representing the GFOA here this afternoon.

We welcome you, though, and are honored that you are here to share with us your expertise and knowledge.

Joseph Hardiman is well known. He is a friend, president of the National Association of Securities Dealers, and not a stranger to this committee at all. And we thank you for being with us.

And John Corzine, the partner and cohead of the Fixed Income Division, Goldman Sachs & Co., is testifying on behalf of the PSA or the Public Securities Association. And, again, I will say to you what I did to our other three. If you can keep your prepared comments down to a relatively short period of time, anything that you would like to have the record reflect will be made a part of the record.

In addition to your prepared testimony, you've had the benefit of hearing the dialog between the SEC, the Fed, and the Treasury and I'd be very much interested in having you pick up on what you heard here. If you had an opportunity to read their testimony ahead of time, then you're luckier than I was. I didn't get it that far in advance. But, nonetheless, I'd like to get from you some response to what they had to say. I think it would make your testimony here today even more significant than it would be with just the prepared statements that you have for us.

So why don't we begin, Mr. Stout, in the order that I have introduced this panel, and I will ask you to proceed first, if you would. And again, welcome to the Senate Banking Committee.

STATEMENT OF ROBERT V. STOUT, FINANCE DIRECTOR FOR RIDGEFIELD, CT, TESTIFYING ON BEHALF OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION

Mr. STOUT. Thank you, Mr. Chairman. I am indeed honored to be here. My name again is Robert Stout. I am the finance director for the city of Ridgefield, CT. I serve on the Government Finance Officers Association's committee on accounting, auditing and financial reporting. And in addition, I am the chairman of the technical committee of the Connecticut Finance Officers Association.

I appreciate the opportunity to appear on behalf of the GFOA and four other organizations to support amending the Government Securities Act to include comprehensive sales practice rules for brokers and dealers trading in governmental securities.

State and local governments and other investors have an interest in assuring that brokers and dealers trading in Government securities are held to a high standard of care and heed rules of fair practice. It is important that Government investors entrusted with public funds have confidence in a broker or dealer in order for investors to make the most advantageous yet appropriate investments for their jurisdictions. Government securities are, of course, among these investments.

Government securities are important to local government cash managers and local government investment is important to the Government securities market. Almost 30 percent of the total cash and securities holdings of municipalities is in Federal securities, according to 1987 census figures.

As of the first quarter of 1990, State and local governments held $342 billion of the total U.S. Treasury debt of over $3 trillion according to the Federal Reserve. This number represents almost 20 percent of the Federal securities market which is not held by foreign investors or Federal agencies.

Most of these public investors are small governments. There are 38,933 general purpose units of government, 85 percent of which have populations under 10,000.

Due especially to the timing of tax receipts, even the smallest governments ought to have significant amounts of money to invest. However, these small jurisdictions are unable to afford highly skilled investment experts to handle their funds. They depend not only on their finance officers, who may lack expertise in all areas of investment, but on those who hold themselves out as experts in the trading and investment fields.

Let me point out that Ridgefield, for example, has a population of less than 30,000 yet, at the end of July when our property tax receipts first come in, we have almost $20 million to invest.

The inclusion of sales practice rules in the GSA was specifically rejected at the time of enactment in 1986. But we believe circumstances have changed. Since that time there has been a large increase in the Federal deficit resulting in more debt being issued at a faster rate, and the instruments have become increasingly complex. Data on sales practice abuses are difficult to collect because of pending litigation and sealed settlements. However, there is growing evidence that State and local governments have increasingly been suffering losses in the U.S. Government securities market due to abuse of sales practices.

Of particular concern to State and local governments are abusive practices regarding suitability, markup, and churning. My written testimony goes into some detail with specific examples of each. I will give you a few other examples.

GFOA members receive many calls from brokers using questionable tactics or offering deals too good to be true. For example, brokers have claimed one finance officer as a trading reference or endorser when soliciting business from another finance office, when in fact no business had ever been transacted with the first individual.

Obligations have been misrepresented as issues of agencies instead of instrumentalities in a jurisdiction whose investment policy prohibited the purchase of instrumentality obligations.

Finance officers who have rejected high yield obligations have often been accused of failing to carry out their fiduciary duties to maximize investment return. The fact that a finance officer may be prudent enough not to purchase a particular obligation or fall for a sales pitch does not obviate the need for regulation of these practices.

Abuses may not often come to the fore, but we know that public moneys paid by the taxpayers and citizens that we all have in common are being endangered.

While we believe that only a small percentage of brokers and dealers are not trading fairly, the ability of these firms or individuals to operate in this fashion should be eliminated. We assume that representatives of the securities industry would also support this view.

The GFOA policy recommends that public investors exercise caution in the investment of public funds. Finance officers are advised to have written investment policies, to make sure that their dealers have copies of these policies as well as risk constraints and trading requirements, and to obtain competitive bids and proposals from securities dealers.

Governmental investors are also advised to be aware of reasonably foreseeable risks of market price loss, ill-liquidity, nonmarketability, or default of investments prior to purchase.

In addition to working with Members of the House and the Senate in developing legislation that would include comprehensive sales practice rules, the GFOA and the Public Securities Association are working on an agreement establishing guidelines for trading relationships between brokers and dealers and governmental units which recognizes the parties' respective responsibilities in and for investments.

But neither the existence of an investment policy, nor a broker-dealer agreement can guard against abusive sales practices. That is why the GFOA and other organizations support the inclusion of sales practice rules in the Government Securities Act, and why we are encouraged by the Treasury Department's proposed legislation which includes sales practice rules comparable to those in other markets.

The Government securities market is the last fertile ground for unscrupulous and incompetent dealers. The promulgation of such rules regulating similar activities has curtailed the opportunities for sales practice abuse in both the municipal and corporate securities markets.

Principles of fairness require that the act be amended to provide for sales practice rules applicable to all investors, including governmental investors. Increased confidence in the market will be an incentive for the purchase of Government securities, particularly given the turmoil in other areas of the financial industry.

Mr. Chairman, the GFOA urges this subcommittee to grant Federal agency rulemaking authority for sales practice rules in the trading of Federal Government securities and to lift the restrictions on the NASD in enforcing sales practice rules for its membership. The legislation should include carefully drawn standards to be met by the rulemaker in order to protect all investors without regard to size of portfolio, include a meaningful role for the SEC, and address the conflict of interest concerns that we have raised in our written testimony.

New sales practice rules should be appropriately similar to those of other regulated securities markets. The GFOA also endorses the granting of explicit enforcement authority to bank and nonbank regulators.

We appreciate your interest in this matter and we look forward very much to working with you.

[The complete prepared statement of Robert V. Stout follows:]

Testimony of Robert V. Stout
on behalf of
Government Finance Officers Association (GFOA)

and
National League of Cities
National Association of Counties
National Association of State Retirement Administrators
National Corporate Cash Management Association

before the
Subcommittee on Securities
United States Senate
Committee on Banking, Housing and Urban Affairs

June 12, 1991

INTRODUCTION

My name is Robert V. Stout. I am the Finance Director for the City of Ridgefield, Connecticut and a member of the Government Finance Officers Association's (GFOA) Committee on Accounting, Auditing and Financial Reporting. I am here today on behalf of GFOA and four other organizations. GFOA is a national professional association of 12,400 state and local government officials, both elected and appointed, whose responsibilities include all the disciplines related to public finance.

THE NEED FOR INVESTOR PROTECTION

Why is investor protection so crucial for state and local investors? State and local governments have an interest in assuring that brokers and dealers trading in government securities are held to a high standard of care and heed rules of fair practice. It is important that governmental investors, entrusted with public funds, have confidence in a broker or dealer in order for them to make the most advantageous yet appropriate investments for their jurisdictions. Periodically, due especially to the timing of tax receipts, governments, even small ones, have significant amounts of money to invest. Cash-flow needs require that funds be immediately available throughout the year.

State and local governments are significant customers of federal government securities and have an immediate and direct interest in seeing that the market is sound. Almost 30 percent of the total cash and security holdings of municipalities is in federal securities, according to 1987 Census figures. As of the first quarter of 1990, state and local governments held $342 billion of the total U.S. Treasury debt of over $3 trillion. This represents approximately 20 percent of the federal securities market that is not held by foreign investors or federal agencies (Federal Reserve Bulletin, Vol. 77, No. 3, March 1991, Table 1.41).

In taking their fiduciary responsibilities seriously, finance officers attempt to maximize their jurisdiction's investment earnings by investing in what they understand to be "safe" obligations, but with which they may lack a thorough technical understanding. Finance officers have the continuing responsibility for balancing safety, liquidity, and yield. The pressure for increased returns in times of declining revenues is another significant factor affecting investment decisions. Jurisdictions rely on the information, advice, and recommendations received from those who purport to be experts. This is no less true in the investment area than in other areas in which public officials function.

Let me point out some characteristics of state and local governments that we believe are particularly significant in this discussion. In addition to the 50 state governments, there are 83,186 units of local government. Of these, 38,933 are general-purpose local governments -- counties, municipalities, and townships -- while the remainder represent school districts and special districts. About 85%, or 33,211, of these general-purpose local governments have populations under 10,000.

Small jurisdictions that are unable to afford highly skilled investment experts to handle their funds instead depend on public servants who may be part-time employees, and officials with numerous other responsibilities. Investment advisors are costly whether they are government employees or independent advisers who are normally compensated on the basis of a percentage of the investment portfolio.

INVESTMENT POLICIES AND PRACTICES

Many jurisdictions have investment policies, both written and unwritten. These policies guide the procedures and objectives instituted by elected and appointed officials to be used in investing public funds. An increasing number of jurisdictions are creating detailed written policies to direct their money managers. Written policies typically specify not only the types of instruments in which public funds may be invested but also the types of institutions and dealers with which business may be transacted.

GFOA has long advised its members to exercise caution in the investment of public funds. It is GFOA policy that investors obtain competitive bids and proposals from securities dealers, and that the finance officers secure acknowledgement from their depositories and dealers of receipt of written copies of their investment policies, risk constraints, and trading requirements. Governmental investors are also advised to be aware of reasonably foreseeable risks of market price loss, illiquidity, nonmarketability, or default of investment instruments prior to purchase. In 1984, GFOA approved model investment legislation for state and local governments that provides a universe of appropriate investment instruments and outlines a series of considerations that should underlie the application of an investment policy at a state or local government level.

As part of this continuing effort, GFOA and the Public Securities Association are attempting to reach consensus on an agreement that would provide guidelines for establishing a trading relationship between broker/dealers and governmental units. This would assist all parties to a transaction in understanding the information to be disclosed by broker/dealers and governmental investors and recognizes the participants' respective responsibilities for dealing with the suitability of investments. Clearly, GFOA does not expect nor advocate that dealers become insurers against loss by customers that may result from market fluctuation or miscalculation by the investor.
However, not even adoption of GFOA's investment guidelines, the existence of an investment policy, nor an agreement with a broker or dealer can guard a jurisdiction against abusive sales practices.

SALES PRACTICES

According to the General Accounting Office report, U.S. Government Securities: More Transaction Information and Investor Protection Resources Are Needed (September 1990), the U.S. Treasury raised $1.2 trillion in 1989 by the sale of its securities. The types of instruments traded range from "plain vanilla" Treasury obligations to derivative instruments of uncertain characterization and risk. While investment in some of these instruments is relatively risk-free and easily understood, investment in others may involve a great deal of risk and may be appropriate for only the most sophisticated and well-schooled investors. Since the 1986 enactment of the GSA, the federal deficit has grown substantially, more debt has been issued at a faster rate, and the instruments have become increasingly complex. Indeed, we are told by securities regulators that even they are often baffled by some of the federal products now entering the market.

The GAO report indicates that losses to state and local governments as a result of improper sales practices in government securities are increasing. Of particular concern are abusive practices regarding suitability, markup, and churning. Investor protection and specific concerns about repurchase agreements motivated Congress to enact the Government Securities Act in 1986; investor protection should be the focus of amendments to the Act during the reauthorization process as well.

Suitability concerns the relationship between a particular instrument and a customer's constraints and affinity for risk. Because of the risk associated with some government obligations (e.g., zero-coupon instruments and mortgage-backed securities), a given instrument may not be appropriate for a specific investor. Prudent cash management for most state and local governments decrees that long-term investments are generally unsuitable for them because such investments tie up funds needed for more immediate purposes. Losses may occur if long-term securities must be sold in order to satisfy cash-flow needs.

Loss alone does not determine unsuitability. A jurisdiction may invest in an instrument that results in a better-than-expected return, or it may have a mix of investments that include both winners and losers, resulting in no net loss. In either case, those investments may have been unsuitable given the needs and policies of that jurisdiction.

For example, the State of South Carolina is currently investigating a county's loss of $1.4 million after $9.3 million was invested in a number of mutual funds, primarily funds trading in high-yield government securities, in contravention of the state's public funds investment law. The investment reportedly resulted from a "cold call" from a Florida broker/dealer named High Yield Management, Inc. State officials are trying to determine what the broker knew about the suitability of the investments.

The markup problem is based on the size of the commission relative to the current price of the security. For transactions registered with the Securities and Exchange Commission (SEC), any markup over ten percent of the base price is deemed fraudulent by the SEC. For registered securities, National Association of Securities Dealers' (NASD) members are subject to a five percent guideline, depending on the security and the market for the security. There are, however, no guidelines applicable to U.S. government securities transactions. Because of the volume of government securities traded, most of which are large dollar transactions, most brokers and institutional investors consider a "reasonable" industry markup to be less than one percent -- normally around one-quarter of one percent, depending, again, on the particular instrument.

For example, the Wall Street Journal of April 15, 1991, reported on brokered transactions in mortgages backed by the Government National Mortgage Association, or Ginnie Mae, in which the markup was said to go as high as six percent, in a market where markup is normally around 1/16 of a point, or .0625 percent, according to the PSA as reported by the Journal.

Currently, there is no requirement that markups be disclosed to customers prior to purchase of instruments. Excessive markups can be generated by the size of the lot or lots purchased. Purchases of smaller or odd lots will result in a higher markup and higher costs to a government than a purchase of a single large lot. This is a cost that should be disclosed to the customer and that may influence the customer's decision to purchase particular instruments.

Churning pertains to broker-controlled trading in a customer's account that is excessive given the customer's investment objectives and that is undertaken for the purpose of generating commissions.

For example, West Palm Beach, Florida, sued several investment firms for inducing the city to enter into an excessive number of transactions, many also unsuitable. In a 21-month period, the firms made over 1,000 transactions worth $2 billion. Investments included 30-year bonds and reverse repurchase agreements.

Data on sales practice abuses are difficult to collect because of pending litigation and sealed settlements and thus the extent of abuse is difficult to document. However, there is growing evidence that state and local governments have increasingly been suffering losses in the U.S. government securities market due to abusive sales practices. Inflated price markups, misleading sales pitches, and the placement of unsuitable investments are being reported by various jurisdictions.

Two well-known examples of losses sustained after investing in government securities occurred in San Jose, California, and McLennan County, Texas. During 1982 and 1983, the City of San Jose invested the $750 million from its pooled cash resources in long-term government bonds with average maturities of 17 years. When interest rates went up and long-term government bond values fell, the city borrowed against these bonds in order to meet their day-to-day obligations and to buy more long-term bonds, assuming that the market would rebound. Eventual losses amounted to $60 million.

The extensive complaint in this case included causes of action for unsuitability and churning, among others. Suitability charges were supported by evidence that the brokers were aware of what was permissible under the city's investment guidelines and that speculative trading was not allowed. Evidence of churning was presented showing that, by October 1983, the trading volume was 460 trades per month. Settlements in this case were reached with 11 defendant brokers. Because the settlements are sealed, the amounts involved are unknown. However, following a seven-month trial, a jury verdict against the remaining two defendants resulted in an additional award of over $18 million.

McLennan County, Texas, had used only bank certificates of deposit as investments until 1989 when a broker suggested that the county invest in short-term government obligations. These were held to maturity and the county received a more favorable return than on its previous bank investments. When a "cold call" was received from a different broker later that year, offering long-term government securities and promising no risk, the county auditor began investing the county's idle funds in these obligations, with the broker's commission averaging between three and five percent. A routine independent auditor's report indicated at one point a loss of $2 to $3 million on a $13 million investment. The eventual sale of the securities, sold in order to meet the payroll, resulted in a net loss of $100,000 and the delay of several county projects.

In addition to cases that have been or are being pursued in the courts, GFOA has collected other examples from around the country that demonstrate instances of excessive markup, unsuitability, and churning. GFOA members report that they are the recipients of many calls from brokers using questionable tactics or offering deals too good to be true.

One member received a call from a broker with whom the city had dealt previously, who offered "government guaranteed" Student Loan Marketing Association instruments, or Sallie Maes, at 17 percent, when the return on similar instruments was eight to nine percent. The reason for the high rate of return? The instruments were denominated in New Zealand dollars, and the broker assured this finance officer that there was no currency risk.

Members also report that brokers have used other finance officers as trading references or endorsers, when in fact the only contact with the alleged reference was a call soliciting business. Finance officers have been subjected to numerous calls from the same broker in the course of a day, offering different instruments each time. Finance officers have been accused by brokers and dealers of failing to carry out their fiduciary duties if they reject high-yield obligations.

Finally, Mr. Chairman, I call to your attention the report released May 7, 1991, by the Resolution Trust Corporation (RTC) concerning losses in the government securities market by savings and loan associations. While this report did not concern governmental investors, I mention it to illustrate that even "institutional investors" can run a risk when trading with government securities brokers and dealers. The activities cited in this report include examples of churning and suitability in addition to improper activities by some bank officers.

These are the types of sales practices that we know are occurring, Mr. Chairman. The fact that a finance officer may be prudent enough not to purchase a particular obligation or fall for a phony sales pitch does not obviate the need for regulation of these practices. In every instance, the cases that eventually come to the public's attention are the most egregious. Finance officers do not routinely report the day-to-day problems at the time they occur. It is clear, however, that abusive practices occur even though they may not often come to the fore and that public monies -- those dollars paid by the taxpayers and citizens we have in common -- are being endangered. Even if it could be determined, as we believe, that only a small percentage of brokers and dealers are not trading fairly, certainly there should be some recourse against these firms or individuals, and we assume that this is also the position of the securities industry. Even if the percentage of the overall market in which abuses occur is small, this amount may comprise a large percentage or dollar amount of a particular entity's budget or retirement fund.

THE NEED FOR SALES PRACTICE RULES

The need for inclusion of sales practice rules in the Government Securities Act has now been recognized by almost every major federal agency involved in the market (as indicated by the Department of Treasury's legislation), industry representatives, public officials, and the Congressional watchdog, GAO. They recognize that the government securities market is the last fertile ground for unscrupulous or incompetent dealers. We applaud the Treasury

Department's inclusion of sales practice rules in its legislation, and particularly support the provision that would afford government securities investors with sales practice protections comparable to those available in other securities markets.

Distinctions between sales practices of government securities and other securities are unwarranted. The promulgation of rules regulating similar activities has curtailed the opportunities for sales practice abuses in municipal and corporate securities markets, and the window of opportunity in the government securities market should be slammed shut. Principles of fairness require that traders dealing in the same activities should be held to the same standards of practice. It is clearly time that the Act be amended to provide for sales practice rules that apply to all brokers and dealers in U.S. government securities and are applicable to all investors, including governmental investors.

There is no evidence that the corporate or municipal securities sales practice rules have overly burdened either market. Any additional costs incurred have not substantially impeded the sales of these obligations. Where there is less market risk, as evidenced by the existence of sales practice rules, investors are often willing to receive a lower yield in exchange for the additional safety. In fact, increased confidence in the market should serve as an incentive for the purchase of government securities, particularly given the turmoil in other areas of the financial industry. In a market the size of the federal securities market, the costs would be so widely distributed that any effects should be minimal.

The vast majority of broker/dealers trading in government securities are already complying with similar rules and procedures in their trading of other securities, and would need only to apply their systems to this market. Any burden placed on them as a result of new sales practice rules should not significantly increase their existing administrative responsibilities or costs. Despite the specter that has been raised of increased costs being passed on to taxpayers, no substantive estimates have been provided to support this claim.

RULEMAKING AUTHORITY

GFOA, in support of the concept of self-regulation, endorses the lifting of restrictions on the NASD to promulgate and enforce rules for its members. In addition, we agree with the GAO and the SEC that federal agency rulemaking will be the most effective means of communicating to all market participants that Congress intends to require certain reasonable standards of conduct in the trading of federal securities. This would also ensure that both bank and non-bank dealers will be governed by the same sales practice rules.

GFOA takes no position on which entity should be granted ultimate federal rulemaking authority. The Association appreciates the fact that the GAO and the joint Department of the Treasury, SEC, and Board of Governors of the Federal Reserve System studies of the Act find that Treasury has provided balanced regulatory treatment and has been effective in promulgating rules for which it currently has jurisdiction under the Act. Treasury's legislation would grant it any new rulemaking authority with regard to sales practice rules. It has argued that its knowledge of the market, its responsibility to protect the liquidity and efficiency of the market, and its desire to minimize the cost of borrowing render it the logical choice for rulemaker. In requesting this authority, Treasury has also emphasized its role as the largest issuer of federal debt.

It is precisely this last fact which concerns GFOA. The appearance of a potential or actual conflict of interest if rulemaking authority over transactions in its own obligations is granted to Treasury may undermine the integrity of the market which the inclusion of sales practice rules is designed to strengthen. Questions arise, for example, as to how strict a rule an issuer may write or how stringent enforcement may be if the sale of obligations is the issuer's overriding concern.

This conflict issue was raised before the Senate Banking Committee during its consideration of the 1986 Act. While the committee was satisfied at that time that the safeguards contained in that legislation were sufficient for those particular activities, the introduction of new sales practice rules and responsibilities into the Act raises the conflict issue anew and highlights the need for additional safeguards.

GFOA's primary concern lies with the content of the sales practice rules, but we urge this subcommittee to examine all potential rulemakers having expertise in securities regulation and to consider all alternatives when granting rulemaking authority.

ENFORCEMENT AUTHORITY

GFOA supports granting authority for enforcement of sales practice rules to bank and non-bank regulators. Some broker/dealers are already subject to enforcement through their exchanges or bank regulators, but many dealers remain unregulated. This results in uneven protection for the investor and unfair competition among dealers. For those agencies currently handling enforcement matters, the knowledge and resources to handle such enforcement already exist. In addition, the lifting of restrictions on NASD will enable it to handle enforcement for its members.

GFOA also endorses a meaningful role for the SEC. The SEC is already responsible for dealer registration and has regulatory and enforcement authority for newly registered broker/dealers under the Act. It has expertise in both rulemaking and enforcement, and GFOA believes that it would be perceived as an impartial party in the regulation of government securities.

CONCLUSION

In conclusion, Mr. Chairman, GFOA urges this subcommittee to amend the Government Securities Act to grant federal agency rulemaking authority to adopt sales practice rules in the trading of federal government securities and to lift the restrictions on the NASD in enforcing sales practice rules for its membership. We recommend that the legislation include carefully drawn standards to be met by the rulemaker in order to protect all investors, including governmental investors of public funds, without regard to size of portfolio or other potentially exclusionary characteristics, and to address any conflict of interest concerns. We further recommend that the legislation require that new sales practice rules be appropriately similar to those in other regulated securities markets. GFOA endorses the granting of explicit enforcement authority to bank and non-bank regulators. Every state and local government has the right to expect brokers with whom it trades to give it relevant information about the nature and risks of potential investments, to charge a fair markup or commission, and to undertake only that trading necessary to fulfill a client's investment objectives.

We appreciate your interest in this matter, Mr. Chairman. GFOA will be happy to assist you in any way as you address this issue.

Questions regarding this testimony should be addressed to Betsy Dotson, GFOA Federal Liaison Center, 1750 K Street NW, Suite 200, Washington, DC 20006, (202) 429-2750.

Senator DODD. Very good. Very good testimony. Thank you. Mr. Hardiman.

STATEMENT OF JOSEPH R. HARDIMAN, PRESIDENT OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, WASHINGTON, DC

Mr. HARDIMAN. Thank you, Mr. Chairman. I am pleased to have this opportunity to appear before you to discuss the authorization of the Government Securities Act of 1986, Senate bill 1247.

I might say, at the outset, that it's nice to feel wanted, given the testimony of the previous panel.

While my written statement sets out the NASD's support for the need for expanded access to Government securities pricing information, my comments today will focus on the need for sales practices rules for the Government securities markets.

The NASD examines 63 dealers that specialize in Government securities and more than 1,300 diversified broker dealers that engage in Government securities transactions.

Even though the New York Stock Exchange and the bank regulators have the authority currently for surveillance of abuses or unethical sales practices, under the Government Securities Act of 1986, the NASD cannot do so for the Government securities activities of its members.

Since these dealers sell substantially the same products to the same types of investors, regardless of who regulates them, the omission of sales practice enforcement authority for the NASD has created a regulatory gap that should be closed if investors are to be accorded fair and even protection. We are pleased, I might add, to have the support of the SEC, the Federal Reserve Board, and the Treasury to that end.

Abuses in the Government securities markets generally do not involve primary dealer activity in purchasing those securities from the Government and then selling them to sophisticated institutional buyers or other dealers. The problem area is in the secondary market, mostly involving nonprimary dealers executing transactions with unsophisticated institutional and individual customers.

As the Government securities markets have grown in size and complexity, the potential for abuse has been increasing especially as individual, municipal, and small institutional investors in recent years increasingly seek what they believe is greater safety in investments related to a Government security.

These investors are, indeed, encouraged by new products that make it easier for them to invest in Government securities. These products include mortgage-backed securities, Treasury STRIPS, and interest only and principal only securities which are issued or guaranteed by agencies of the U.S. Government.

While marketed as Government securities, these investments can be very speculative and investors may be unfamiliar with their complexity and their risk.

For example, one firm was marketing a Fannie Mae interest only, or "I/O" to retail investors who purchased that security on margin. Since the security provided rights to interest payments only, its value could swing substantially as interest rates fluctuated or as prepayments in the particular mortgage pool accelerated. This firm sold $30 million of this security to retail customers on the basis that it was the direct obligation of the Government agency without meaningful disclosure as to the more speculative nature of the security.

Currently, the NASD can take disciplinary action against one of its members in connection with Government securities sales practices activities only where the violative conduct rises to the level of fraud, thus requiring proof of fraudulent intent. This allows higher markup and lower standards than the accepted norm for other securities because of the difficulty in proving that intent.

The self-regulatory approach built on just and equitable principles of trade has considerably more flexibility because it is based on acceptable business practice standards that are developed by the experts in the area. It also utilizes the judgment of the alleged violator's peers in determining whether violations of these standards have occurred.

The development of new Government securities products makes the extension of the NASD's sales practice authority even more critical. Time and again, in municipal securities in the 1970's and Government securities repurchase agreements in the 1980's, a vacuum in regulation has resulted in serious abuse. Congress now has an opportunity to address the vacuum in sales practice regulation and avoid serious exposure for investors.

The NASD is sensitive to the concerns expressed regarding the impact of markup and sales practice regulations on the efficiency and liquidity of the Government securities market. We are aware that the Government securities market warrants different treatment than the market for other securities.

The NASD's committee and rulemaking structure is organized to respond to the unique nature of different securities. We have developed markup policies for many different types of securities. In each case, the NASD establishes a committee composed of knowledgeable practitioners in the area to develop those markup practices.

In this manner, Government securities dealers will have a substantial participation in the development and adoption of regulations in the Government securities market. With industry participation the various types of Government securities and their specific characteristics and markets will be considered in establishing markup policies. Industry participation, we believe, is the major advantage of self-regulatory rulemaking and enforcement.

The NASD has historically applied its sales practices requirements with substantial input from the securities industry. In particular, suitability requirements have been applied on a case-by-case basis with careful attention to the security involved, the sophistication of the customer, and the control over the investment decision. This careful balancing process ensures investor protection without—and I emphasize—without making the securities industry insurers of the performance of the investment itself.

The NASD strongly supports the stated goal for Treasury's S. 1247, the "Government Securities Act of 1991," to provide for sales practice regulations for the Government securities market, and ensure the availability of Government securities pricing information. We would suggest, however, certain modifications to the bill.

First, the bill should eliminate the existing prohibition in section 15A(g) that restricts the ability of the NASD to impose standards of training, experience, and competence for associated persons of Government securities dealers.

Second, the bill's requirement that the NASD rules be "consistent" with the rules enacted by the Treasury is, in our judgment, unnecessary.

Section 19(b) of the 1934 act already requires that the Commission approve NASD rules only if they are consistent with the act and with the rules and regulations adopted under it. In light of this test, the separate Treasury rule standard is redundant and may cause unnecessary questions as to whether it imposes a standard different than that contained in section 19(b) of the 1934 act.

Finally, in addressing one of the questions that you asked, Mr. Chairman, the Treasury proposal does raise a question as to which Federal agency should be responsible for overseeing the promulgation of fraud and sales practices rules for Government securities dealers. The NASD has always supported a functional approach to regulation whereby activities of multifaceted entities are regulated according to the function being performed and not according to the characteristics of the entity itself. Under this approach, securities activities should be regulated by the SEC. Since our inception in 1939, we have worked closely and effectively with the SEC, an agency that we believe has demonstrated a continuing ability to adopt rules that enhance investor protection without imposing unnecessary costs on the securities industry. In light of this well-established relationship between the SEC and the NASD, we believe the extension of sales practices oversight authority of the SEC would be preferable. If Congress determines, however, that the Department of the Treasury should be authorized to enact sales practices rules because of their strong interest in an efficient and fair Government securities market, the NASD will be pleased to work closely with both Treasury and the SEC to that end.

As you pointed out, Mr. Chairman, it is essential to preserve the extraordinary liquidity and efficiency of the U.S. Government securities market while assuring that the market is indeed fair to all participants. We believe that extension of sales practice regulation to Government securities dealers under our jurisdiction will provide benefits to the investing public with minimal impact on the efficiency of the market and on the associated costs for the industry. We believe that the Treasury bill, S. 1247 is an important, necessary step toward regulating this important market, and, with the suggested changes, as well as any modifications on the jurisdictional issue, should be enacted.

[The complete prepared statement of Joseph R. Hardiman follows:]

NASD

Testimony of Joseph Hardiman
President
National Association of Securities Dealers

Before a Hearing of the
Securities Subcommittee of the
Banking, Housing and Urban Affairs Committee
United States Senate

Concerning

Reauthorization of the Government Securities Act of 1986

June 12, 1991

I am Joseph Hardiman, President of the National Association of Securities Dealers, Inc. (NASD). I am pleased to have this opportunity to appear before you to discuss the reauthorization of the Government Securities Act of 1986 (GSA) and developments in the government securities markets since it was enacted.

Your invitation letter asked that I provide my views on the Department of the Treasury's bill, S. 1247, the "Government Securities Act Amendments of 1991". I will comment on a number of issues concerning the bill: whether the Treasury's rulemaking authority under the Government Securities Act of 1986 should be reauthorized, whether federal authority to write sales practice rules for the government securities market should be granted, and whether there is a need for expanded access to government securities pricing information, as well as other related issues.

I. The NASD

The NASD is registered with the Securities and Exchange Commission (SEC) as a national securities association under the Securities Exchange Act of 1934 (the "1934 Act"). The NASD is the only association so registered. It is a self regulatory organization (SRO) and an operator of electronic securities markets. As a market operator it runs the National Association of Securities Dealers Automated Quotation System, or NASDAQ Stock Market, which is the second largest securities market in the United States and among the five largest in the world. As an SRO it is charged with the responsibility of regulating the over-the-counter securities markets, including, within the scope of the pertinent securities acts, the municipal and government securities markets.

The NASD has 5,600 broker-dealer members employing 411,000 registered sales persons and principals. The scope of the NASD's regulatory jurisdiction extends to all such members and their associated persons. While the 2,300 staff of the SEC and the roughly half that number of state securities regulatory staff must deal with all aspects of securities regulation, the 1,940 staff of the NASD focuses on regulation of its members which is only a segment of federal and state regulation. Through close cooperation with federal and state regulators, overlap and duplication is minimized, freeing governmental resources for securities regulation to be focused on other areas.

The NASD carries out its examination, disciplinary, and other regulatory responsibilities through its Washington headquarters and 14 offices located in major cities throughout the country. In addition to disciplinary committees consisting of industry volunteers that work with the regional offices, the NASD has a National Market Surveillance Committee that deals specifically with trading and market related issues. A committee of the NASD Board of Governors, the National Business Conduct Committee, reviews as an appellate body the disciplinary activities of the District Business Conduct Committees and the Market Surveillance Committee, to assure fairness and, to the extent possible, uniformity in disciplinary actions. Final NASD disciplinary actions can be appealed to the SEC and then to the United States Courts of Appeals.

The NASD is governed by a 30 member Board of Governors drawn from its membership, leaders of industry and academia, executives of NASDAQ companies, and the public. The Board, through a series of standing and select committees, monitors trends in the industry and promulgates rules, guidelines, and policies that it deems necessary to protect investors, issuers, and market intermediaries.

II. Extension of Treasury Rulemaking Authority

The NASD supports extending Treasury's existing rulemaking authority in the government securities market. Exercise of this authority by Treasury has improved investor safety while minimizing the impact of regulation on the efficient functioning of this extremely important and large market. Moreover, Treasury has consulted and coordinated with the SEC, the Federal Reserve Board, the NASD, and the various other enforcement and self-regulatory entities both during the rulemaking process and thereafter. The NASD believes the Treasury has properly discharged its rulemaking responsibilities since the GSA was passed.

III. Sales Practice Authority and Related Issues

Under the GSA, the NASD has no authority to apply its rules regulating sales practices to the government securities firms for which it has regulatory responsibility. Inconsistently, however, the GSA does not prohibit registered securities exchanges, such as the New York Stock Exchange (NYSE), from applying its sales practice rules to government securities dealers. Similarly, bank regulators have indicated that their examiners have the authority to apply the Municipal Securities Rulemaking Board's sales practice guidelines to banks' government securities activities.

The NASD examines approximately 63 dealers that specialize in government securities and more than 1,300 diversified broker-dealers that engage in government securities transactions. Even though the NYSE, which has the examination responsibility for 168 broker-dealers, and the bank regulators, which have the examination responsibility for 280 bank dealers, have the authority to surveil for abuses or unethical sales practices, the NASD cannot do so for its members. Since these dealers sell substantially the same products to the same types of investors regardless of who regulates them, the omission of sales practice enforcement authority from the NASD under the GSA has created a significant regulatory gap that should be closed if investors are to be accorded even and fair protection.

The Government Accounting Office's September 1990 study titled U.S.Government Securities: More Transaction Information and Investor Protection Measures Are Needed (GAO Report) states:

> ...sales practice rules that supplement the basic anti-fraud provisions of the securities laws have become a fixture in securities markets in the United States. If these rules make sense for other securities markets, then they also make sense for the government market as well, because there are similarities for abuse in both types of markets.

The NASD agrees with this conclusion as well as with the GAO recommendation in Chapter 3 of its report in a section entitled "NASD Should Have Authority to Enforce Sales Practice Rules in the Government Securities Market," where the GAO recommended:

> ...that Congress amend Section 15 of the Exchange Act (and such other statutes as may be necessary) to authorize a federal agency to adopt general rules of fair practice applicable to all government securities brokers and dealers. Self-regulatory organizations and bank regulators should also be authorized to develop and enforce specific requirements within the context of general rules. The rules, at a minimum, should cover dealer pricing practices (mark-ups) and investor suitability requirements.

The Department of the Treasury, the Comptroller of the Currency, the Public Securities Association, the New York Stock Exchange, and the Government Finance Officers Association have also expressed their general support for sales practice regulation for government securities.

The abuses in the government securities market generally do not involve primary dealer activity in purchasing securities from the government and selling them to sophisticated institutional buyers or other dealers. The problem area is the secondary market, mostly involving non-primary dealers executing transactions with unsophisticated institutional and individual customers. While the focus of potential abuses when the GSA was written in 1986 was on repurchase agreements, there have since been widely publicized cases involving government securities that have involved abusive sales practices. As the government securities markets have grown in size and complexity, the potential for abuse has been increasing, especially among less sophisticated individual and small institutional investors.

This growth in the potential for abuse is especially pronounced as individual investors in recent years increasingly seek what they believe is greater safety in any investment related to a government security. These investors are growing in numbers and are encouraged by the creation of products that make it more attractive for them to invest in government securities. These products include mortgage backed securities, either pass-through pools or collateralized mortgage obligations (CMOs) that are issued or guaranteed by agencies of the U.S. government. CMOs that are issued by trusts or limited purpose corporations are already subject to the NASDs sales practice rules. An additional product category is interest only (I/O) and principal only (P/O) products, which separate the interest from the principal of a government security and create two separate products. These include Treasury STRIPS for Treasury securities with a maturity of ten years or more, and I/Os and P/Os of agency securities such as FNMA. Also excluded from sales practice regulation are government securities derivatives, such as over the counter options and forwards on government securities.

While marketed as government securities, these investments can be very speculative and investors may be unfamiliar with their complexity and risks. For example, one firm was marketing a FNMA interest only to retail investors who purchased the I/O on margin. Since the security provided rights to interest payments only, its value could swing substantially as interest rates fluctuated or as prepayments in the particular mortgage pool accelerated. This firm sold $30 million of this security to retail customers on the basis that it was the direct obligation of a government agency, with no meaningful disclosure provided as to the more volatile and speculative nature of the security. Investors would, in our judgement, benefit from sales practice regulations -- especially those governing excessive mark-ups and unsuitable recommendations -- which are applied to other securities.

These risks extend to state and local government. The Government Finance Officers Association (GFOA), which represents state and local government financial officials, indicates that over 33,000 general purpose local governments have populations under 10,000, which from time to time have significant tax receipts to invest on a short term basis. These investments are often made by officials with numerous other responsibilities and with little prior exposure to investments who would benefit from sales practice rules that apply to government securities purchased from NASD dealers.

Currently, the NASD can take disciplinary action against one of its members in connection with government securities sales practice activity only where the violative conduct rises to the level of fraud, thus requiring proof of fraudulent intent. This approach allows higher markups and lower standards than the accepted norm for other securities, because of the difficulty in proving that intent. The NASD's enforcement mechanism has considerably more flexibility because it is based on acceptable business practice standards developed by experts in the area and utilizes the judgement of the alleged violator's peers in determining whether violations of those standards have occurred.

For example, since NASD's suitability and markup rules (which, with industry input, could be expanded to specifically address markups in government securities) are standards of ethical business conduct and do not require proof of fraudulent intent, violations can more easily be prosecuted. The NASD has been enforcing its Mark-up Policy on dealer transactions in corporate securities since the early 1940's and has not encountered significant difficulties in administering the policy or establishing criteria and guidance for our membership. One of the primary reasons our mark-up regulation has worked is the governance structure outlined below. Our Mark-up Policy was developed and is amended, interpreted, and enforced by industry professionals having extensive knowledge of -- and experience in -- the specific area being regulated.

The NASD is sensitive to the concerns expressed on the impact of mark-up regulations on the efficiency of the government securities market. We are aware that the government securities market is unique and warrants treatment different from the market for other securities. The NASD's committee structure is organized to respond to the unique nature of different securities. We have developed mark-up policies for many different types of securities, such as options and limited partnerships.

In each case, the NASD establishes a committee composed of industry professionals with expertise in the area to develop specific mark-up policies. In this manner, government securities dealers would have substantial participation in the development and adoption of regulations in the government securities market and, with industry participation, the various types of government securities and their specific characteristics and markets would be considered in establishing mark-up policies. Industry participation, we believe, is the major advantage of self regulation organization rulemaking.

Rules developed by self regulatory organizations capitalize on the flexibility needed to keep regulation current with developments in the market and provide the inter-market comparability needed. The NASD believes that sales practice rules are more appropriately developed at the SRO level where the standards of business practice and ethics play a much larger role and the expertise of those in the business is utilized in developing the appropriate standards. The NASD has historically applied its sales practice requirements with substantial input from the securities industry. In particular, suitability requirements have been applied on a case by case basis with careful attention to the security involved, the sophistication of the customer and control over the investment decision. This careful balancing process ensures investor protection without making the securities industry insurers of the performance of the investment.

Our members already have in place compliance procedures dealing with sales practice rules such as suitability and mark-ups which are applicable to all of their transactions except for those involving government securities. We do not believe that anything more than a minimal increase in cost would result from extending these procedures to government securities transactions, yet the potential benefit in terms of investor protection should be substantial. Federal oversight and approval would, of course, be continued and is supported by the NASD.

The development of new government securities products makes the extension of the NASD's sales practice authority even more critical. Time and again, in municipal securities in the 1970's and government securities repurchase agreements in the 1980's, a vacuum in regulation has resulted in serious abuse. Congress now has an opportunity to address the vacuum in sales practice regulation and avoid serious exposure for investors.

The NASD also supports the GAO recommendation to require qualifying examinations for government securities brokers and dealers. While such an examination is no guarantee of competency or integrity, it would help to assure that government securities principals and sales personnel understand, among other requirements, customer suitability requirements for the riskier government zero coupon and mortgage backed securities now being bought by less sophisticated retail customers. Qualification examinations would be a valuable adjunct to sales practice rules as a protection to investors. The government securities market is the only area of the securities industry not currently subject to such requirements.

IV. Availability of Government Securities Pricing Information

The NASD supports expanding access to government securities pricing information on a real time basis to anyone willing to pay the appropriate fees. In most instances, increased disclosure not only adds to the efficiency and liquidity of the market, but also substantially increases investor protection by providing easy and open access to pricing information.

Expanded access to this information allows institutional and retail customers to evaluate objectively the quotations that the dealer is offering them, allowing those customers to compare their quoted price with the price quoted to other dealers to see if it is fair and reasonably related to the interdealer market price.

More widely available pricing information also permits more competition between dealers since it increases their ability to quote competitive markets. Moreover, because options and futures depend on accurate pricing information on the securities underlying their products for their pricing and hedging strategies, more complete information will allow market participants to take larger positions and thus narrow spreads in the derivative markets. Finally, the availability of information promotes pricing efficiency, or the relationship between the price quoted and the security's actual value as determined by an active secondary market. Because of these important benefits, the NASD supports expanded access to government securities pricing information.

V. Treasury Bill - S. 1247 the "Government Securities Act Amendments of 1991"

Your invitation to testify specifically requested our views on S. 1247, the "Government Securities Act Amendments of 1991", which was introduced by Senators Dodd and Gramm at the request of the Treasury Department.

As we understand it, the bill would amend the 1934 Act to:

- Extend permanently Treasury's authority to promulgate rules and issue orders on government securities transactions effected by government securities brokers and dealers.

- Authorize Treasury to promulgate anti-fraud rules applicable to all government securities brokers and dealers and to promulgate sales practice rules for government securities brokers and dealers that are financial institutions.

- Authorize the NASD to prescribe sales practice rules for its members, subject to SEC approval with Treasury consultation.

- Authorize Treasury to promulgate rules relating to the disclosure of government securities price and volume information.

- Make several technical and conforming amendments to the 1934 Act.

The NASD strongly supports the Treasury's stated goal to provide for sales practice regulations for the government securities market and to ensure the availability of government securities pricing information. We would suggest however, certain modifications to the bill.

First, the bill should also eliminate the existing prohibition in Section 15A(g)(3)(D) that restricts the ability of the NASD to impose standards of training, experience, and competence for associated persons of government securities dealers. Such authority, which the NASD has for other activities of its members, would include fidelity bonding, qualifications, and NASD margin requirements.

We believe that the rationale behind the GAO's recommendation that the NASD should receive sales practice authority -- that those rules make sense for other markets and should apply to the government market because there are similarities for abuse in both markets -- applies just as forcefully here to the need for financial and qualification standards.

Second, we believe that the requirements that NASD rules be "consistent" with rules enacted by the Treasury is unnecessary. Section 19(b) of the 1934 Act already requires that the Commission approve NASD rules only if they are consistent with the Act and rules and regulations adopted under it. Thus, the SEC, which must make a determination of consistency with the Treasury rules under Section 3 of the bill, is already required to make a finding of consistency with any -- SEC, Treasury, or other -- rules written under the 1934 Act by the current requirements of that Act. In light of this test, the separate Treasury rule standard is redundant and may cause unnecessary questions as to whether it imposes a standard different from the Section 19(b) standard in the 1934 Act. We therefore urge that this proviso in Section 3 of the bill be deleted as duplicative at best, and as potentially harmful to the current Section 19(b)(2) at worst.

Finally, the Treasury proposal raises the question as to which federal regulatory agency should be responsible for adopting the fraud and sales practice rules for government securities dealers. The NASD has historically been supportive of a functional approach to regulation. Functional regulation posits that entities are regulated according to the functions they are performing, and not according to the characteristics of the entity itself. Thus, for example, securities activities would be regulated by the SEC. Since our inception in 1939, we have worked closely and effectively with the SEC, an agency that we believe has demonstrated a continuing ability to adopt rules that enhance investor protection without imposing unnecessary costs on the securities industry. In light of the strong, established relationship between the SEC and the NASD, we believe the extension of sales practice authority to the SEC would be preferable. Indeed, this might be accomplished simply through the removal of the restrictions in Section 15A(f) and (g), without the need for additional federal rulemaking. If Congress determines, however, that the Department of the Treasury should be authorized to enact sales practice rules because of their strong interest in an efficient and fair government securities market, the NASD will be pleased to work closely with both Treasury and the SEC in that effort.

VI. Conclusion

It is essential to preserve the extraordinary liquidity and efficiency of the U.S. government securities market. We believe that extension of sales practice regulation to government securities dealers under our jurisdiction will provide benefits for the investing public with minimal impact on the efficiency of the market and on the associated costs for the industry. We also support wider dissemination of government securities pricing information, which is also needed to further protect investors in this extremely important and growing market. We believe that the Treasury bill, S. 1247, is an important, necessary step toward regulating this important market, and with the suggested changes, should be enacted.

Thank you for the opportunity to testify on this topic, which is important to the NASD and its regulation of the securities markets. I would be pleased to answer any questions you may have.

Senator DODD. Thank you very much, Mr. Hardiman.

Mr. Corzine, I apologize for mispronouncing your——

Mr. CORZINE. I'll survive.

Senator DODD. I'll bet that happens with some frequency. Tell me if it does, does that happen with some frequency?

Mr. CORZINE. Zine, Corzine.

Senator DODD. I know. I said—but I didn't introduce you that way. I said Corzine when I first introduced you.

STATEMENT OF JOHN CORZINE, PARTNER AND COHEAD, FIXED INCOME DIVISION OF GOLDMAN SACHS & CO., NEW YORK, NY, TESTIFYING ON BEHALF OF THE PUBLIC SECURITIES ASSOCIATION

Mr. CORZINE. I will accept any of those kinds of anomalies.

We have many friends here and we'll go with the flow as they say.

On behalf of the Public Securities Association, I appreciate the opportunity to speak before this subcommittee on the reauthorization of the Government Securities Act.

PSA, as you know, is an international trade association representing approximately 300 banks, dealers, and brokers that underwrite trade and distribute U.S. Government mortgage-backed municipal securities. All the primary dealers are recognized by the Federal Reserve Bank of New York and all major mortgage-backed securities dealers are PSA members.

I am a member of PSA's board and a former chairman of its Government securities division, as well as the association. I am also a partner of Goldman Sachs where I cohead the fixed income division and am a member of the management committee.

I am also chairman of the Treasury Borrowing Advisory Committee. However, I want to make clear that I am not testifying in that capacity today.

First, I will comment briefly on the importance of the Government securities market and the effectiveness of the 1986 legislation.

Then I will address each of the specific issues that have generally arisen in connection with the reauthorization.

Senator DODD. Can you pull that microphone a little closer to you?

Mr. CORZINE. I am sorry.

Senator DODD. Thank you. I appreciate that.

Mr. CORZINE. The Government securities market is the largest, most liquid and efficient securities market in the world. This liquidity facilitates the implementation of domestic monetary policy and allows the Treasury to issue debt at the lowest possible cost to taxpayers.

Since any regulation generates cost, Congress narrowly targeted the 1986 act to address specifically identified weaknesses in the Government securities market, such as capital adequacy rules, financial reporting, and registration.

This targeted approach was adopted to avoid excessive regulation which would potentially impair the market's efficient operation. We believe that this approach struck the optimal balance between maintaining market integrity and low-cost financing of the national debt.

Given the success of the 1986 act, we believe that this same balance should serve as the foundation for the reauthorization of the legislation.

With respect to reauthorization of the Treasury's rulemaking authority, PSA supports the Treasury as the rulemaker for the Government securities market. In 1986, Congress selected Treasury as the rulemaker because of its market expertise and cost sensitivity which would ensure that the GSA did not inadvertently damage a market that is so vital to the Government's ability to finance the Federal deficit.

We believe that the past 5 years have validated Congress' conclusions. The Treasury's regulations have improved investor safety without imposing overly burdensome regulatory requirements and have been uniformly applied to all dealers.

Accordingly, PSA believes that Treasury's rulemaking authority should be extended.

On the issue of price dissemination, PSA supports expanded access to Government securities pricing information. During the last 2 years, PSA has worked with the industry to create an industrywide joint venture to disseminate Government securities prices.

The company, known as GOVPX, Inc., will go live Sunday evening, June 16. GOVPX will disseminate real-time quotation and volume information on a 24-hour global basis on all Treasury bills, notes, and bonds. PSA believes GOVPX satisfies all the criteria identified by the GAO in its recent report to Congress.

The GAO first originally concluded that the private sector was the best vehicle for achieving expanded access to Government securities prices. Many doubted the success of any private sector efforts. We believe that this industry has been remarkably proactive on this issue and that GOVPX obviates the need for legislation.

As a profit-driven enterprise and a competitive information vending marketplace, GOVPX will evolve its business plans to meet future market demands for information. Legislation on this issue would be inconsistent with the GAO recommendation that regulations serve only as a last resort if private sector efforts fail.

Moreover, as noted by the Federal Reserve Board, legislation could constrain rapidly changing market practices.

Regarding sales practices, consistent with the views expressed by the SEC, the Fed, and the Treasury in their joint report to Congress, PSA believes that there is no evidence of widespread sales practice abuses in the Government securities market. Therefore, we do not think a change from Congress' 1986 view limiting this regulation is warranted.

Nevertheless, PSA does not oppose reasonable rules of fair practice, provided that the rules are tailored to the Government market and reflect the responsibilities that exist on both sides of a trade.

Those reasonable rules could include general prohibitions against successive markups in churning, and ones that promote the suitability of investments.

To protect the market against unnecessary costs of overregulation, sales practice rules should embody certain general principles.

First, sales practice rules must hold institutional investors, whether public or private, to a professional standard of competence and accountability for their investment decisions.

Those who accept the professional responsibility of managing assets and liabilities and matching cash receipts to disbursements must, by definition, be deemed to be institutional investors.

Second, sales practice rules must reflect the degree of control that a dealer has over an investor's account. Where an institutional investor has competitive relationships with more than one dealer, only the investor has sufficient knowledge to be held responsible for selecting the specific investment strategy for generating its revenues.

Rules that ignore these principles run the risk of turning trading relationships into investment management relationships and will transform dealers into assurers against investor loss.

We cannot emphasize strongly enough that such an across-the-board reallocation of responsibility will slow trade execution, limit investor's options, and increase costs to the market and all of its participants.

Rather than socializing costs in this manner, a better balance between investor protection and market efficiency would be achieved if institutional investors, lacking appropriate expertise, were encouraged to obtain investment management services for a fee.

Finally, we believe that any sales practice rules must meet the principle to be applied uniformly to all categories of Government securities dealers to ensure a level playing field for all market participants.

On extending SIPC insurance, like the Treasury, Fed, and SEC, PSA has not taken a position on whether SIPC insurance should be extended to specialist Government securities dealers. We think that Congress should study the issue further, focusing particularly on the additional exposure to fund and the cost to the market of extended coverage.

In conclusion, the precision with which this market has been regulated in the past has achieved an optimal balance between investor protection and avoidance of market disruption. In a market this size, even modest overregulation will significantly increase costs.

We believe the dealer community has been remarkably proactive in meeting the public policy mandate to disseminate price information and in its willingness to work on implementing reasonable sales practice rules.

We believe that this is an ideal opportunity for Congress and the industry to work together to develop rules that protect both investors and the market.

I would like to thank you for providing PSA with the opportunity to testify today. As we go forward, we would be delighted to provide you with any assistance in gathering information and drafting legislation.

Senator DODD. Thank you very much, John.

I had enjoyed immensely, by the way, the opportunity to appear before the PSA not too many weeks ago. It seems like it was a year ago. It was only a month ago, but time goes by so quickly.

I want to thank you very much and thank all of you for your comments.

Let me address some brief questions to you, and let me begin with you, if I can, Mr. Stout.

You heard the testimony of the SEC and the Fed, and there have been other commentators as well, that have suggested that there is no real demonstrated need, as they see it, for sales practice rules in the Government securities markets. In fact, they are rather forceful about it, although recognizing that there may be some difficulties down the road.

But, you take a very different position and a very strong position. I read your testimony. In fact, in the lengthier piece you actually go through and cite a whole bunch of cases very specifically, anecdotally, involving Texas I think was one, and I remember there was another one that was striking. There were a number of them. It was a rather lengthy list that you provide.

At any rate, your testimony highlights the concerns that Government securities dealers have taken advantage of some investors. I don't want to suggest that you or your colleagues are necessarily unsophisticated at all, quite to the contrary, you do a remarkable job and deal with a great deal of resources. But in your written testimony you talk about the 33,000 communities of populations of under 10,000 in this Nation.

I do not know what sort of mil rates they can charge in order to hire a good finance officer, but I presume in many cases it is a part-timer and is somebody who is doing it voluntarily perhaps in some ways, running another business as well and trying to help take care of the local town, and frankly you would not expect them necessarily to be sophisticated.

So you seem to focus on that concern. I do not like using the word "unsophisticated." Perhaps we should say a less experienced, less knowledgeable individual who is not a professional in this area. Let me try and frame it that way, rather than "degree of sophistication."

What I am wondering here is whether or not, in your view, you can somehow segregate out the unsophisticated and the sophisticated, or the professional and the nonprofessional in this area of sales practice rules?

Is that possible? Or is that just being naive on my part?

Mr. Stout. Well, it is probably not ever completely possible, Mr. Chairman. I think, without citing all the examples that I gave in my written testimony, let me first say that the fact that I could cite six, seven, or eight——

Senator Dodd. I know you can.

Mr. Stout [continuing]. Proves that the problem is not a huge problem, but I think that in fact when governments are losing money and we can rectify that with some fairly, we believe, simple rule changes that would make them comparable to corporate and municipal issuers, that it is something we should look into.

One of the things we thought about, well, wouldn't it be nice if we could come up here and testify to you that somebody lost several million dollars through one of these practices. We found it difficult to get a finance officer to walk up and sit down and say, gee, I got taken.

Maybe that is one of the reasons I was here.

Senator Dodd. A "former." A former finance officer. [Laughter.]

Mr. STOUT. Let me point out, for example——

Senator DODD. How is Ridgefield doing, anyway? Is it doing OK over there?

Mr. STOUT. Ridgefield is doing——

Senator DODD. I want to give you an opportunity to say what a heck of a job you're doing.

Mr. STOUT. Actually, by our town charter, you are correct when you say our treasurer is an elected treasurer. It is a part-time position, and she is totally in charge of all of the investments made by the town.

We pay her $9,000 a year to invest, as I said in my testimony, over $20 million. I mean, you mess those kinds of funds around on Wall Street and they're going to find that somewhat staggering.

I will not say she is unsophisticated. I think your phrase "less sophisticated" is probably a better phrase. I think she does a good job, and I think the town is very lucky to have her.

But as you know, that could change at the next election. I think she——

Senator DODD. Is she a Democrat, or a Republican? [Laughter.] Do not answer. [Laughter.]

Mr. STOUT. I think you were just in Ridgefield, Mr. Chairman.

Senator DODD. I had brunch there on Sunday.

Mr. STOUT. You did not meet her, so you can——

Senator DODD. So I will draw some conclusions about that. [Laughter.]

Mr. STOUT. But the rules will help. The right phrase I think is "level the playing field." I think that these kinds of rules would not impose any additional cost, since they are doing it for the other kinds of markets they are working in.

I think it would help all of us to do better.

One other side that you may want to think about is, the very fact that there are some losses I think is encouraging many governments to go the other way and invest in "ultrasafe" investments. They may be losing 100 basis points, or 50 basis points because they will not invest in things that do not sound at all right, that do not fit exactly with what they want. I think that may be the other one. We are not getting the return that we could have if there were some of these less sophisticated money managers that had a little more confidence in the market.

Senator DODD. Good point. Good point.

Joe, on page 3 of your testimony, you state that "abuses in the Government securities market are mainly in the secondary market."

Is that what you suggest?

Mr. HARDIMAN. Yes.

Senator DODD. And to quote you, you say "mostly involving nonprimary dealers executing transactions with unsophisticated institutions and individual customers."

If NASD is given sales practice rulemaking authority, how would you distinguish between your two types of investors that I talked about with Bob Stout, here?

Mr. HARDIMAN. The rulemaking authority for us involves a couple of different disciplines.

One is in the markup area, and I think that really goes to the nature of the security.

And as I pointed out in my testimony, we would involve the experts in the Government securities market to determine what is a fair and reasonable markup on various types of securities.

The other is a sales practices area.

And in the sales practices area, we have found no substitute for a case-by-case determination as to whether there has been an abuse.

And those case-by-case determinations take into account the nature of the security involved, the relative degree of sophistication or unsophistication of the individual involved.

They also take into account the control that the seller or the buyer may have over the investment decision.

So I'm not so sure there's any magic formula that we can cite for you, other than to say to you that for the last 50 years, our members have been making those determinations involving all types of securities, equities, corporate debt securities, more recently municipal securities. We believe that the same types of historic practices should be applied to the Government securities area where in fact we have seen some evidence of possible sales practice abuses that do not rise to the level of fraud, and we can't do much about them.

Senator **Dodd**. You want to comment on this, Mr. Corzine?

Mr. **Corzine**. Well, I think it's important to make sure that I don't get identified with a view that any losses, any loss is a good loss or is not an important situation.

But I think one has to put the overall sales practice abuse issue in the context of the total amount of volume and activity that occurs in a market that has $120 billion worth of turnover in a given day.

And I think PSA would argue that these are relatively de minimis in total.

That does not mean that they are unimportant.

And I think that most of us would find it perfectly acceptable to have the NASD involved in the administration of sales practices rules for the small portion existing if there was uniformity across all participants in the marketplace.

I think our organization's hung up on the fact that there may be carve outs of groups of participants that would not be subject to the same rules, and therefore still be potential exposures developed in the marketplace for those de minimis number of places where losses occur.

And I think that's more where our philosophy is coming from. We have no great antipathy to the sales practice rules.

I'd say, as a market participant, I am not sure that these are going to protect the unsophisticated investor that we were trying to define earlier from the unscrupulous participant.

There are still some sales practice abuses in some regulated markets.

We think this is a relatively de minimis part of the overall activity in the Government securities business.

Senator **Dodd**. OK.

Joe, you point out that the New York Stock Exchange already has sales practice authority over its members, and that bank regulators can apply certain municipal sales practice rules to banks' activities.

And so logically, and you pointed this out, the only gap in sales practice regulation appears to be NASD members.

In fact, I always remember the wonderful line of Senator Conkling from New York.

His line was that "patriotism was the last refuge of the scoundrel until they discovered the word 'reform.'"

And I'm wondering here, are we talking about the last refuge of the scoundrel?

We've heard references made today that now that the people involved in penny stock frauds have been hounded out by Richard Breeden, they're shopping for a place to go.

Are we talking about the last refuge of the scoundrel?

Mr. HARDIMAN. Well, the scoundrels always seem to find the least regulated markets at some stage. And if we've stepped up the regulation in the municipal securities markets which was done by Congress in the 1970's and the Government securities markets as far as the repurchase agreements, problems in the 1980's and the penny stock problems in the late 1980's, I suspect that it won't take long for those scoundrels to find the least regulated markets. And, indeed, in my written testimony I cited the example of a firm that had sold some $30 million worth of I/O's to individual investors with minimum disclosure.

I would add, without disclosing the name of that entity, that it was formerly a well-known penny stock firm. So that I suspect that without higher authority to deal with many of these non-New York Stock Exchange member firms that are actively involved in selling Government securities, not just Treasury notes, bills, and bonds, but the more esoteric types of securities, that they will end up finding that refuge.

Senator DODD. Do you want to comment on that at all, John?

Mr. CORZINE. Well, I think that's consistent with the view that scoundrels do find places to operate. I don't necessarily believe that that will be stopped even if you have sales practice rules implemented. People find ways to circumvent rules on a fairly regular basis.

I still would argue that this is a fairly small part of the overall Government securities business and you have to weigh against that, balance against that the potential costs of what these regulations might bring to bear on the overall cost and efficacy of the Government securities market.

Mr. HARDIMAN. I don't see that being any significant additional cost frankly. We already have the full apparatus in place, so in terms of additional costs to our members, it should be little or none. In terms of impact on the prices of this huge market I can't see that sales practice regulations protecting the smaller investors—which do in fact represent a very small portion of that huge market—will affect prices much, if at all.

Even though the small investors who would be protected by these regulations are investing what is a sizable sum to them, given the size of the market for Government securities, it's unlikely that sales practice regulation to protect those small investors is going to have a material impact on the cost or the efficiency of the liquidity of that huge primary market and secondary market that exists among big institutions and primary dealers.

Senator DODD. Good point.

Let me come back to you, John, again, on the Gov-Picks issue.

There is suggestion that this never would have happened—you heard that dialog—in the absence of the sort of Damocles not hanging over the head of the industry.

The GAO report and the threat of legislation, all of these things are what drove the industry to establish Gov-Picks.

But putting aside the question of why it's there, at this point, I'm operating under the assumption that for whatever reason it was started, that the intention is to make it work well. And obviously, if it doesn't, you'll be listening to me or someone else here asking you to comment on a specific bill or piece of legislation I have to deal with the issue, rather than inquiring as to how efficiently or how effectively the industry's approach is working.

But before it's even underway there are some critics. Specifically, you've got some potential users of the data from Gov-Picks, such as financial institutions and insurance companies, pension funds, many of them are asserting that while they will be able to get price and quote information, they'll not be able to store, work with, analyze, or use the data at all. Therefore, critics have said that the data is not going to be very useful in the form that is currently being proposed by Gov-Picks.

I wonder how you could respond to that. And is the PSA working with both sides of the industry here as we go forward? I think it is so important—again I am stating the obvious here—but if we have a hearing on how well Gov-Picks is working, you know the first panel I'm going to have up. It's not going to be the people who designed it, it's going to be the people who are using it. So if they are standing up here saying this is just worthless, at some point then you can anticipate the reaction you're going to get from Congress and from others.

So I wonder if you might comment about some of those critics—maybe you want to take the last part of the question first.

Mr. CORZINE. Let me address the current state of what Gov-Picks will be as of Sunday evening when it starts. I don't think anybody thinks that's the state of the art, nor is it the final step of where Gov-Picks will be.

Access at real time data feeds is a fundamental direction that securities markets are taking wherever they are. And while Gov-Picks isn't ready to roll out its ability to provide real time data feeds to clients immediately, I think that that is very near term possible through this facility. And I think to meet marketplace demands, which Gov-Picks is for profit, it will have to provide or other people will step into that void.

You mentioned earlier EJV and their other—or I guess Bob actually mentioned it in his earlier testimony. There are a number of other vendors of information. This information is very valuable. Other people recognize that are in fact at work trying to provide facilities that will disseminate it at a profit. And I think that the industry is moving very quickly along those lines.

And I think once the ball was started, and I think very properly so, by the kind of pressure provided by the regulatory backdrop, I think it now has a life of its own because the timely dissemination of information is very valuable and people recognize that and they are now paying for that with a fee.

So I think it will evolve. I think GOVPX will have many competitors as the Wall Street Journal article today very clearly described the current state of affairs, EJV, Telerate are actively involved in this dissemination of information activity today and there will be other people joining that fray and I think it will be a very competitive marketplace to make sure that some of those complaints that currently exist are quickly addressed. And hopefully Gov-Picks will stay in the stream of activity and keep themselves competitive in the marketplace to provide the kinds of information that are available.

[The complete statement of John Corzine follows:]

Public Securities Association
40 Broad Street
New York, NY 10004-2373
(212) 809-7000 or (212) 440-9400
Telecopier: (212) 797-3895 or
(212) 742-1549

PSA

WRITTEN STATEMENT OF JON S. CORZINE
MEMBER OF THE BOARD OF DIRECTORS,
PUBLIC SECURITIES ASSOCIATION

HEARING BEFORE THE SUBCOMMITTEE ON SECURITIES
OF THE COMMITTEEE ON
BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

JUNE 12, 1991

Good afternoon.

On behalf of the Public Securities Association, I appreciate the opportunity to speak before the Securities Subcommittee at this hearing on the reauthorization of the Government Securities Act of 1986 (the "GSA").

PSA is an international trade association representing approximately 300 banks, dealers and brokers that underwrite, trade and distribute U.S. government securities, mortgage- and asset-backed securities, municipal securities and money market instruments. All of the primary dealers, as recognized by the Federal Reserve Bank of New York, and all major mortgage-backed securities dealers, are PSA members.

I am a member of PSA's Board of Directors and a former Chairman of its Government Securities Division. I am also a Partner of Goldman, Sachs & Co., Inc., where I am co-head of the fixed-income division and a member of the Management Committee. I am also Chairman of the Treasury Borrowing Advisory Committee, however, I am not testifying in that capacity today.

First, I will comment briefly on the importance of the government securities market and the effectiveness of the 1986 legislation. Then, I will address each of the specific issues that have arisen in connection with the reauthorization.

General Comments

For purposes of the GSA, the "government securities" market encompasses Treasury securities, as well as mortgage-backed and non-mortgage-backed securities issued by federal agencies and government-sponsored enterprises. As Congress noted in 1986, the government securities market plays a critical role in the U.S. financial system. It is the primary market for financial investment that contributes to the stability and liquidity of the financial system as a whole.

The government securities market is also the largest, most liquid and efficient securities market in the world. As of the second quarter of 1990, there was over $3.5 trillion in government securities outstanding.1/ In 1990, average daily trading volume in U.S. Treasury securities among only the primary dealers equalled $118 billion.2/ Average daily trading volume in agency and government sponsored enterprise mortgage-backed securities among only the primary dealers equalled $12 billion.3/ This liquidity both facilitates the implementation of domestic monetary policy through open market operations and allows the Treasury to issue federal debt at the lowest possible cost to taxpayers.

1/ Federal Reserve Board Bulletin (October 1990).

2/ Statistics provided by the Federal Reserve Bank of New York at PSA meeting held on April 26, 1991.

3/ Id.

As a result, and since any regulation generates costs, Congress stated that the 1986 Act was narrowly tailored to address specifically identified weaknesses in the government securities market. This approach was specifically adopted to avoid excessive regulation that would impair the efficient operation of the market, compromise the execution of domestic monetary policy or increase the cost of financing the Federal debt.[4]

We believe that these principles, reflected in the 1986 Act, produced an exemplary piece of securities regulation which protects investors and is supported by the industry. This approach strikes the optimal balance between maintaining market integrity and low-cost financing of the national debt. Given the success of the 1986 Act, we believe that these same principles should serve as the foundation for the reauthorization legislation.

There are four issues that have become the focus of the reauthorization legislation:

1) should Treasury be reauthorized as the rulemaker in the government securities market,

2) should Congress require price information on government securities to be made available to any participant in the market willing to pay the appropriate fees,

3) should Congress authorize the adoption of rules governing sales practices in the government securities market, and

4) should SIPC insurance be extended to customer accounts held by broker-dealers transacting business exclusively in government securities.

I will briefly address each of these issues.

Reauthorization of the Treasury

PSA supports reauthorizing the Treasury as the rulemaker for the government securities market. In 1986, Congress selected Treasury as the rulemaker because its market expertise and responsibility for managing the public debt would ensure that the GSA did not inadvertently damage a market that is so vital to the government's ability to finance the federal deficit. We believe that the past five years have validated Congress' conclusions. The Treasury's regulations have improved investor safety without imposing overly burdensome regulatory requirements.

4/ Senate proceedings on final passage of GSA, Congressional Record at 15796-7 (October 9, 1986).

As required, Treasury has consulted with other regulators and the industry; relied, to the extent possible, on existing regulations; and applied its rules fairly and uniformly to all categories of government securities broker-dealers.

Accordingly, PSA believes that Treasury's rulemaking authority should be extended. Treasury's market knowledge and cost sensitivity, which were the bases for Congress' initial decision to empower Treasury, warrant the continuation of its regulatory authority.

Government Securities Pricing Information

PSA supports expanded access to government securities pricing information. Throughout 1990 and 1991, PSA has worked with the industry to create an industry-wide joint venture to disseminate government securities prices. The company, known as GOVPX, Inc., will go "live" on June 16th. GOVPX will disseminate real-time price information on a 24-hour, global basis. Initially, GOVPX will disseminate information on all Treasury bills, notes and bonds. Information to be disseminated on all of these securities will include:

-- last executed trade prices and trade volumes,
-- "best bid" quotation information and the offer that accompanies the best bid,
-- yields corresponding to bid quotations and last executed trade prices,
-- whether a trade was executed on the bid or on the offer side of the market, and
-- the aggregate volume of trading that occurs on a daily basis in each of these securities.[5]

GOVPX will include information on all primary dealer trades executed through all of the interdealer brokers who do not currently disseminate price information.

In developing its initial product, GOVPX balanced the need for significantly increasing the amount of price information disseminated to the public with the desire to begin disseminating information as quickly as possible. Enhancements to the initial product, as well as additional products, are already under consideration.

In its 1990 report to Congress, the GAO identified several key elements that should be reflected in any legislation requiring broader dissemination of price information.[6] GOVPX satisfies all of those elements. In particular, there are no artificially-induced time lags, all trade execution information is being disseminated and the system is not exclusive. Firms providing information to GOVPX can compete with it directly and any vendor or end user throughout the world wishing to purchase the information may do so at the appropriate fee.

---

[5] Sample GOVPX pages are attached as Exhibit 1.

[6] U.S. Government Securities: More Transaction Information and Investor Protection Measures are Needed at 85-86 (September 1990) (the "1990 GAO Report").

In December 1987, when the GAO first examined this issue, it concluded that the private sector was the best vehicle for achieving expanded access to government securities prices. Only if those efforts failed, according to the GAO, should there be federal regulation.7/ Many doubted the success of any private sector efforts. We believe that this industry has been remarkably proactive on this issue and that GOVPX obviates the need for legislation. Legislation would be inconsistent with the GAO recommendation that regulation serve only as a last resort. Moreover, legislation could constrain rapidly changing market practices.8/

Sales Practice Rules

PSA believes that there is no evidence of widespread sales practice abuses in the government securities market.9/ Therefore, we question whether regulation in this area is warranted. Nevertheless, we would not oppose reasonable rules of fair practice that were tailored to the government securities market.

In 1986, Congress explicitly concluded that the cost of sales practice rules for the government securities market exceeded the benefits.10/ The GAO report to Congress recommended sales practice rules for the government securities market. However, the GAO stated that it did not assess the prevalence of sales practice abuses nor did it evaluate the effectiveness of sales practice rules in preventing abuse.11/ More recently, the joint report to Congress issued by the Treasury, the SEC and the Federal Reserve Board of Governors concluded that abusive sales practice problems

---

7/ U.S. Government Securities: An Examination of Views Expressed About Access to Brokers' Services at 74, 76 and 78 (December 1987).

8/ See letter from Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System to Senator Christopher Dodd (March 6, 1991) (the "Fed Comment Letter").

9/ See Fed Comment Letter at 2; Letter from Richard Breeden, Chairman, Securities and Exchange Commission to Senator Dodd at 11 (February 26, 1991); Letter from L. William Seidman, Chairman, Federal Deposit Insurance Corporation to Senator Dodd at 2 (January 23, 1991).

10/ See S. Rep. No. 426, 99th Cong., 2d Sess. 10, 13-14, 16 and 20.

11/ 1990 GAO Report at 48.

have not been widespread and that several recent well-publicized losses are not necessarily attributable to such practices. This view was echoed in the responses of the SEC, Fed and FDIC to the request of Senators Dodd and Heinz for comments on the reauthorization and in SEC Chairman Breeden's recent testimony before this Subcommittee. In addition, the government securities market continues to be overwhelmingly institutional in nature; the percentage of Treasury securities held by individuals and state and local governments remains largely unchanged from 1986.12/ Given earlier concerns regarding the costs of regulation and the absence of market abuse or change in the investor base, we do not think a change from Congress' recent view limiting sales practice regulation is warranted.

Nevertheless, PSA would not oppose reasonable rules of fair practice that, for example, prohibit excessive mark-ups and churning and promote suitability of investments. However, such rules must be tailored to the government securities market, the variety of securities it encompasses and the speed at which transactions are executed. To ensure that the market is protected against disruption, rules should reflect that responsibilities exist on both sides of a trade. Accordingly, it is imperative that sales practice rules embody certain general principles.

First, sales practice rules must hold institutional investors, whether public or private, to a high standard of competence and accountability for their investment decisions. Entities who accept the professional responsibility of managing assets and liabilities and matching cash receipts to disbursements must, by definition, be deemed to be institutional investors.

Second, sales practice rules, like existing case law imposing civil liability for churning and unsuitable transactions, must reflect the degree of control that a dealer has over an investor's account. Dealers can be held to a higher standard of responsibility where they have exclusive contractual relationships with an investor or where they exercise de facto control over an investor's account. However, where an investor enters into competitive relationships with more than one dealer, each dealer will be unaware of the business that the investor is transacting with the other dealers. For example, Investor A's investment guidelines limit it to investing no more than $5 million in 2-year Treasury securities. Investor A regularly solicits competitive bids from five dealers. Dealer B agrees to sell Investor A $5 million of 2-year Treasury securities. However, Dealer B has no way of knowing whether Investor A has also bought these securities from any of the other dealers, thereby violating its own investment guidelines. Similar problems would arise in connection with requiring dealers to monitor an investor's prescribed portfolio diversification requirements or hedging limits. In these cases, only the investor has sufficient knowledge to be held responsible for selecting the specific investment strategy for generating revenues.

12/ Federal Reserve Bulletin (October 1990).

Rules that ignore these principles will turn all trading relationships into investment management relationships and will transform dealers into insurers against investor loss. Such an across-the-board reallocation of responsibility will slow trade execution, limit investors' investment options and increase costs to the market and all of its participants. Rather than "socializing" costs in this manner, a better balance between investor protection and market efficiency would be achieved if institutional investors lacking appropriate expertise were encouraged to obtain investment management services for a fee.

We note that, although the U.S. federal securities laws routinely distinguish between institutional and retail investors,13/ they have never distinguished between public and private investors. Governmental entities, charged with a duty of filling a public trust, must have adequate resources to satisfy their responsibilities. Lack of resources cannot serve as a basis for shifting their responsibilities to the marketplace. Groups representing state and local government finance officers have themselves developed recommendations governing public investors' investment procedures. For example, the Municipal Treasurers Association's (the "MTA") recent investment policy certification program calls on public investors to develop internal review procedures for monitoring compliance with their own investment guidelines. The MTA also recommends that "permissible investments" include not only those securities in which a public investor may legally invest, but also those that the investor is "trained and competent to handle". Similarly, the National Association of State Treasurers recently developed a "pooling program" under which states manage local government investment pools for the benefit of their localities. These programs are designed to achieve economies of scale for public investors. We support these programs and believe that they fairly allocate responsibility between investors and dealers.

In addition, any sales practice rules must give due consideration to the meaning of "suitability" in the government securities market. Government securities, unlike equities, do not raise issues regarding the credit quality of the investment. Also, unlike municipal securities, no issues arise regarding the tax profile of the investor.

13/ See for example, the definition of "accredited investor" in Section 2(15) of the Securities Act of 1933; the definition of "accredited investor" in Rule 501(a) of Regulation D; the definition of "qualified institutional buyer" in SEC Rule 144A(a)(1); and the definitions of "major U.S. institutional investor" and "U.S. institutional investor" in SEC Rule 15a-6(b). Copies of these provisions are attached as Exhibit 2.

Congress should also carefully consider the approach taken in any rules regulating excessive mark-ups. To determine whether a mark-up is excessive, the NASD currently uses a "5% guideline" in conjunction with certain general principles regarding the type, price and availability of the security and whether a mark-up pattern exists. The MSRB relies on similar principles but does not employ a specific numerical standard. The State of Arkansas Securities Commission recently developed a lengthy list of numerical standards for different types of securities. The government securities market encompasses a wide range of securities. For example, we would expect that standards governing excessive mark-ups for actively-traded Treasury securities would differ significantly from those governing less liquid mortgage-backed derivative instruments. Given the diversity of the market and the rapid development of new instruments, we believe that rules embodying general principles and avoiding numerical standards would establish a more comprehensive, longer-lasting approach to this issue.

Finally, any sales practice rules must apply uniformly to all categories of government securities dealers. The government market encompasses financial institutions, diversified broker-dealers and specialist broker-dealers and rules are enforced by at least 7 regulatory bodies. Therefore, it is important to ensure that any additional regulations provide a reasonably level playing field for all market participants.

Extension of SIPC Insurance

Like the Treasury, Fed and SEC, PSA has not yet adopted a position on whether to expand SIPC insurance to the customer accounts of specialist government securities dealers. We believe that this is an issue that requires further consideration by Congress. In particular, Congress should consider the impact of any such extension on the SIPC insurance fund and what costs would be associated with extended insurance coverage.

Conclusion

In sum, the surgical precision with which this market has been regulated in the past has achieved an optimal balance between investor protection and avoidance of market disruption. In a market this size, even modest overregulation will significantly increase cost. In considering what regulation is necessary to protect investors, Congress must also consider what regulation is necessary to protect the market.

I would like to thank you for providing PSA with the opportunity to testify before you today. As we go forward, we would be delighted to provide to you whatever assistance is necessary in gathering information and drafting legislation.

2027L

EXHIBIT 1

```
04/15 11:31:23 EST COPYRIGHT GOVPX INC 1991 COMPOSITE       PG 90
MATURITY  COUPON        BID OFFR  B-YLD    PRICE  VOL  YIELD A-VOL
 3M 07*11             5.58  /57    5.733 H 5.58    25  5.733   247
 6M 10*10             5.60  /65    5.923 H 5.62     5  5.859   162
 1Y 04*09             5.83  /81    6.181 T 5.83     5  6.181  2132
 2Y 03/93  7 1/8 100.13+ /136    6.888 T00.140    1  6.879  1464
 3Y 02/94  6 7/8  99.09+ /100    7.148 T99.096    5  7.145   966
 5Y 03/96  7 3/4 100.14+ /15+    7.637 T00.14+    1  7.637  2628
 7Y 04/98  7 7/8 100.050 /06+    7.845 T00.060    1  7.840   950
10Y 02/01  7 3/4  98.200 /21+    7.952 H98.20+    1  7.949  1770
30Y 02/21  7 7/8  97.08+ /100    8.110 H97.080   10  8.120   877
```

```
04/15 11:15:52 EST COPYRIGHT GOVPX INC 1991 TREASURY BILLS PG 10
MATURITY  COUPON        BID OFFR  B-YLD    PRICE  VOL  YIELD A-VOL
    04*18                   /60          H 5.70    25  5.780    62
    05*16             5.55         5.652 H 5.52    20  5.622    49
    06*13                                H 5.45     5  5.574    49
    06*20                                H 5.45     2  5.580     2
    07*05             5.00  /51    5.126 H 5.54     1            1
 3M 07*11             5.59  /56    5.743 H 5.58    25  5.733   247
    07*18             5.58  /545         H 5.555   17  5.713   147
    08*29                   /63          H 5.58     5  5.777   115
    09*26             5.60         5.825 T 5.555    5  5.777   110
    10*03             5.00  /67    5.191 H 5.675   51  5.911    66
 6M 10*10                   /66          H 5.62     5  5.859   162
    11*21                   /67          T 5.63     5  5.882     5
    02*13                   /74          H 5.80     1  6.108    21
    03*12             5.00  /73    5.251 H 5.80     1  6.127   255
 1Y 04*09             5.835 /835   6.187 H 5.835   30  6.187  1989
```

```
04/15 11:19:22 EST COPYRIGHT GOVPX INC 1991 MATURITY  2 YR PG 22
MATURITY  COUPON        BID OFFR  B-YLD    PRICE  VOL  YIELD A-VOL
    10/91  7 5/8 100.271 /27+    5.987 H00.27+    1  5.965    11
    11/91 14 1/4         /20+          T04.27                03*27
    11/91  8 1/2 101.12+ /132    5.999 H01.12+    1  5.999    28
    11/91  7 3/4 101.310 /012    4.486 H01.002    2  6.054     2
    12/91  8 1/4 101.150 /160    6.067 T01.160    2  6.021     3
    12/91  8 1/4                                            00*00
    12/91  7 5/8 101.000 /020    6.132 H01.016    1  6.053     1
    01/92 11 5/8                       T03.296               04*12
    01/92  8 1/8 101.140 /156    6.212 H01.160    1  6.131     3
    02/92 14 5/8                                            00*00
    02/92  9 1/8 102.000 /10+    6.593 T02.09+    5  6.228    11
    02/92  8 1/2 101.000 /290    7.275 H01.28+    1  6.218    13
    03/92  8 1/2                       H06.164               04*08
    03/92  7 7/8 101.000 /170    6.768 H01.150               04*12
    04/92 11 3/4 105.000 /070    6.477 T05.070               04*12
```

```
04/15 11:19:39 EST COPYRIGHT GOVPX INC 1991 MATURITY  3 YR PG 31
MATURITY  COUPON      BID OFFR  B-YLD    PRICE  VOL   YIELD A-VOL
    05/93 10 1/8                      H05.314               04*12
    08/93  8 3/4         /230         H03.22+     2   6.993    14
    08/93 11 7/8         /100         T10.060               04*12
    08/93  7 1/2                      H00.16                04*11
    08/93  8 5/8                                            00*00
    11/93  9      104.090       7.147 T04.120               04*12
    11/93  8 5/8                                            00*00
    02/94  9                          H04.13                04*03
```

```
-----
04/15 11:28:06 EST COPYRIGHT GOVPX INC 1991 MATURITY  5 YR PG 50
MATURITY  COUPON      BID OFFR  B-YLD    PRICE  VOL   YIELD A-VOL
    06/94  8 1/2 103.160 /190   7.250 T03.170               04*12
    09/94  8.600         /190         H03.190     1   7.400    55
    10/94  9 1/2         /170         H06.210     2   7.307    63
    11/94  8 1/4         /280         H02.260               04*12
    12/94  7 5/8 100.29+ /300   7.331 T00.29+     9   7.331   292
    01/95  8 5/8 104.000 /000   7.377 H03.300     1   7.396     2
    02/95  7 3/4 101.020 /050   7.422 H01.04+     1   7.398    52
    04/95  8 3/8                      T03.014               04*12
    05/95  8 1/2         /180         T03.170               04*12
    08/95  8 1/2 103.000        7.668 T03.20+     8   7.495     8
    10/95  8 5/8 103.260 /290   7.607 H03.250               04*12
    01/96  7 1/2  99.160 /17+   7.622 H99.160     3   7.622    40
    02/96  7 7/8 100.270        7.659 T00.29+     1   7.639    14
    02/96  7 1/2  99.140 /150   7.637 T99.150     1   7.629    13
 5Y 03/96  7 3/4 100.14+        7.637 T00.150     5   7.633  2586
```

```
04/15 11:29:19 EST COPYRIGHT GOVPX INC 1991 MATURITY  7 YR PG 60
MATURITY  COUPON      BID OFFR  B-YLD    PRICE  VOL   YIELD A-VOL
    04/96  9 3/8 106.240 /260   7.720 T06.250     1   7.713    32
    05/96  7 3/8  98.200 /222   7.705 H98.21+     5   7.694    15
    07/96  7 7/8 100.190 /200   7.731 T00.220               04*12
    10/96  8                          T01.03                04*12
    11/96  7 1/4  97.000 /000   7.924 H97.240     1   7.753    13
    01/97  8     100.300 /000   7.790 T01.030     1   7.756     1
    04/97  8 1/2 103.070 /100   7.817 T03.080     5   7.811    23
    05/97  8 1/2 103.000 /000   7.867 T03.10+    28   7.800    29
    07/97  8 1/2 103.000 /090   7.878 H03.080     1   7.828    23
    08/97  8 5/8 103.000 /000   8.008 H03.11+               04*10
    10/97  8 3/4 104.000 /000   7.949 H04.180     1   7.840    13
    11/97  8 7/8 105.000 /000   7.884 H04.162               04*11
    01/98  7 7/8 100.02+ /05+   7.856 H00.050    10   7.841    42
    02/98  8 1/8 101.000 /000   7.929 H01.030               04*12
 7Y 04/98  7 7/8 100.050 /070   7.845 T00.060     1   7.840   950
```

```
04/15 11:29:53 EST COPYRIGHT GOVPX INC 1991 MATURITY 10 YR PG 70
MATURITY  COUPON     BID OFFR   B-YLD   PRICE   VOL  YIELD A-VOL
    05/98  9     105.000 /000   8.057 T05.310     1  7.881     1
    08/98  9 1/4 106.000 /110   8.143 T07.100     2  7.913     2
    11/98  8 7/8 105.000 /000   7.981 H04.290              04*12
    02/99  8 7/8 105.050 /06+   7.974 H05.10+     1  7.945    58
    05/99  9 1/8                      T06.24      5  7.974    10
    08/99  8     100.060 /000   7.966 H99.290              04*12
    11/99  7 7/8  99.130        7.970 T99.150     1  7.960     2
    02/00  8 1/2                      H03.05      3  7.992    51
    05/00  8 7/8 105.000 /000   8.085 H05.200     1  7.990     7
    05/00  8 1/4                      T00.100              04*11
    08/00  8 3/4 104.24+ /270   8.012 H04.26+     5  8.003    11
    08/00  8 3/4         /000         H06.24      1  7.719    24
    08/00  8 3/8                      T01.20               04*12
    11/00  8 1/2 103.070 /09+   8.011 H03.08+     1  8.004   116
10Y 02/01  7 3/4  98.200 /210   7.952 H98.20+     1  7.949  1770
```

```
04/15 11:31:02 EST COPYRIGHT GOVPX INC 1991 MATURITY 30 YR PG 80
MATURITY  COUPON     BID OFFR   B-YLD   PRICE   VOL  YIELD A-VOL
    08/03  8 3/8                      H00.190              04*11
    11/04 11 5/8                      H26.28               04*12
    05/05 12                          H30.16               04*12
    08/05 10 3/4                      T21.04+     4  8.211     4
    02/06  9 3/8                      T09.16               04*11
    11/07  7 7/8         /180         T98.100     1  8.101     1
    11/12 10 3/8                      T17.17               04*12
    05/14 13 1/4                                           00*00
    05/16  7 1/4                      T88.14               04*10
    11/16  7 1/2                      T91.17               04*09
    05/18  9 1/8                      T07.124              03*25
    02/19  8 7/8                      T05.16               04*10
    08/19  8 1/8                      T99.024     3  8.200     8
    05/20  8 3/4                      H05.29               04*09
30Y 02/21  7 7/8  97.08+ /100   8.118 H97.080    10  8.120   877
```

EXHIBIT 2

Section 2(15) of the Securities Act of 1933

(15) The term "accredited investor" shall mean—

(i) a bank as defined in section 3(a)(2) of the Act whether acting in its individual or fiduciary capacity; an insurance company as defined in section 2(13) of the Act; an investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; a Small Business Investment Company licensed by the Small Business Administration; or an employee benefit plan, including an individual retirement account,
which is subject to the provisions of the Employee Retirement Income Se
Act of 1974, if the investment decision is made by a plan fiduciary, as defin
section 3(21) of such Act, which is either a bank, insurance company, or
tered investment adviser; or

(ii) any person who, on the basis of such factors as financial sophisticatio
worth, knowledge, and experience in financial matters, or amount of assets
management qualifies as an accredited investor under rules and regula
which the Commission shall prescribe.

Rule 501(a) of Regulation D

Rule 501. Definitions and Terms Used in Regulation D.

As used in Regulation D, the following terms shall have the meaning indicated:

(a) Accredited investor. "Accredited investor" shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

(1) Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

(2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

(3) Any organization described in Section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;

(4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

Rule 144A

Reg. § 230.144A. (a) *Definitions*

(1) For purposes of this section, "qualified institutional buyer" shall mean:

(i) Any of the following entities, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity:

(A) Any *insurance company* as defined in Section 2(13) of the Act;

(B) Any *investment company* registered under the Investment Company Act of 1940 (the "Investment Company Act") or any *business development company* as defined in Section 2(a)(48) of that Act;

(C) Any *Small Business Investment Company* licensed by the U.S. Small Business Administration under Section 301(c) or (d) of the Small Business Investment Act of 1958;

(D) Any *plan* established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees;

(E) Any *employee benefit plan* within the meaning of Title I of the Employee Retirement Income Security Act of 1974;

(F) Any *business development company* as defined in Section 202(a)(22) of the Investment Advisers Act of 1940;

(G) Any organization described in Section 501(c)(3) of the Internal Revenue Code, corporation (other than a bank as defined in Section 3(a)(2) of the Act or a savings and loan association or other institution referenced in Section 3(a)(5)(A) of the Act or a foreign bank or savings and loan association or equivalent institution), partnership, or Massachusetts or similar business trust; and

(H) Any *investment adviser* registered under the Investment Advisers Act.

(ii) Any *dealer* registered pursuant to Section 15 of the Exchange Act, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least $10 million of securities of issuers that are not affiliated with the dealer, *provided that* securities constituting the whole or a part of an unsold allotment to or subscription by a dealer as a participant in a public offering shall not be deemed to be owned by such dealer;

(iii) Any *dealer* registered pursuant to Section 15 of the Exchange Act acting in a riskless principal transaction on behalf of a qualified institutional buyer;

NOTE: A registered dealer may act as agent, on a non-discretionary basis, in a transaction with a qualified institutional buyer without itself having to be a qualified institutional buyer.

(iv) Any investment company registered under the Investment Company Act, acting for its own account or for the accounts of other qualified institutional buyers, that is part of a family of investment companies which own in the aggregate at least $100 million in securities of issuers, other than issuers that are affiliated with the investment company or are part of such family of investment companies. "Family of investment companies" means any two or more investment companies registered under the Investment Company Act, except for a unit investment trust whose assets consist solely of shares of one or more registered investment companies, that have the same investment adviser (or, in the case of unit investment trusts, the same depositor), *provided that*, for purposes of this section:

(A) each series of a series company (as defined in Rule 18f-2 under the Investment Company Act [17 CFR 270.18f-2]) shall be deemed to be a separate investment company; and

(B) investment companies shall be deemed to have the same adviser (or depositor) if their advisers (or depositors) are majority-owned subsidiaries of the same parent, or if one investment company's adviser (or depositor) is a majority-owned subsidiary of the other investment company's adviser (or depositor);

(v) Any entity, all of the equity owners of which are qualified institutional buyers, acting for its own account or the accounts of other qualified institutional buyers; and

(vi) Any *bank* as defined in Section 3(a)(2) of the Act, any savings and loan association or other institution as referenced in Section 3(a)(5)(A) of the Act, or any foreign bank or savings and loan association or equivalent institution, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with it and that has an audited net worth of at least $25 million as demonstrated in its latest annual financial statements, as of a date not more than 16 months preceding the date of sale under the Rule in the case of a U.S. bank or savings and loan association, and not more than 18 months preceding such date of sale for a foreign bank or savings and loan association or equivalent institution.

Rule 15(a) - 6(b)

(4) the term "major U.S. institutional investor" shall mean a person that is:

(i) a U.S. institutional investor that has, or has under management, total assets in excess of $100 million; provided, however, that for purposes of determining the total assets of an investment company under this rule, the investment company may include the assets of any family of investment companies of which it is a part; or

(ii) an investment adviser registered with the Commission under section 203 of the Investment Advisers Act of 1940 that has total assets under management in excess of $100 million.

(7) the term "U.S. institutional investor" shall mean a person that is:

(i) an investment company registered with the Commission under section 8 of the Investment Company Act of 1940; or_

(ii) a bank, savings and loan association, insurance company, business development company, small business investment company, or employee benefit plan defined in Rule 501(a)(1) of Regulation D under the Securities Act of 1933 (17 CFR 230.501(a)(1)); a private business development company defined in Rule 501(a)(2) (17 CFR 230.501(a)(2)); an organization described in section 501(c)(3) of the Internal Revenue Code, as defined in Rule 501(a)(3) (17 CFR 230.501(a)(3)); or a trust defined in Rule 501(a)(7) (17 CFR 230.501(a)(7)).

Senator DODD. Terrific.

Well, thank you very much. And obviously, we'll be watching it all very carefully.

Well, you've all been very helpful here this afternoon. And we're deeply grateful for your time and your comments. If you've got additional information you think this committee ought to have, this record will be open so we'd like to have an ongoing dialog with you as we proceed along and deal with this legislation. We've got to deal with it fairly quickly as you know. So I will be deeply interested in your comments as we proceed forward and take a look at what we're going to be proposing. But I do appreciate very much your willingness to be here and your excellent testimony this afternoon. And we'll keep you posted as to how this is progressing.

But, in the meantime, this committee will stand adjourned until further call of the Chair.

[Whereupon, at 4:10 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

THE SECRETARY OF THE TREASURY
WASHINGTON

July 9. 1991

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D.C. 20510-0702

Dear Mr. Chairman:

I am pleased that legislation extending Treasury's rulemaking authority under the Government Securities Act of 1986 and providing for the regulation of sales practices for government securities is scheduled for mark-up by the Senate Banking Committee on Wednesday, July 10. Treasury supports the Committee Print of S. 1247, dated July 2, 1991, entitled the Government Securities Act Amendments of 1991.

We believe that extension of Treasury's rulemaking authority and the new regulatory authority to be provided to the banking regulators and the National Association of Securities Dealers is necessary and appropriate. The amendment will maintain the framework established by the Government Securities Act of 1986 and provide an effective mechanism for the regulation of government securities sales practices. This approach will continue to ensure a balanced regulatory structure for all participants in the government securities market. Additionally, the joint agency evaluation of private sector initiatives regarding the dissemination of government securities price and volume information will allow the further development of these efforts while providing for continued scrutiny.

This legislation serves the public interest, provides that the government securities market remains liquid, competitive and efficient, and ensures that the Federal government's deficit is financed at the least possible cost to the taxpayer.

Sincerely,

Nicholas F. Brady

July 19, 1991

Honorable Christopher J. Dodd
United States Senate
Washington, D.C. 20510

Dear Senator Dodd:

This responds to your request for comments on the July 2, 1992 Committee Print of S.1247, the Government Securities Act Amendments of 1991, which the Senate Banking Committee, on July 9, voted to report to the Senate. A very serious concern is that S. 1247 gives the Treasury Department an effective veto over the actions of independent financial regulators in connection with the exercise of new sales practice rulemaking authority.

Although the bill correctly assigns that function to current financial regulators, it takes the unprecedented step of subjecting the regulatory action of these independent financial regulators to a Treasury veto. This would set a precedent of direct intrusion into the decisions of independent regulators.

Additionally, we find no basis in the hearing record for this veto provision. The Treasury Department's legitimate interest in financing the debt at the lowest possible cost to federal taxpayers could easily be recognized through consultation requirements associated with the new rulemaking authority. The FRB, FDIC, and SEC, as independent financial regulators, share Treasury's concern with the liquidity and efficiency of the markets and have established an excellent record of carrying out consultation and coordination requirements established in other federal laws.

We appreciate the opportunity to comment and urge that before this bill is enacted it be modified to delete the veto provision.

Sincerely,

	Richard C. Breeden	L. Wm Seidman
Alan Greenspan Chairman of the Board of Governors of the Federal Reserve System	Richard C. Breeden Chairman of the Securities & Exchange Commission	L. William Seidman Chairman of the Federal Deposit Insurance Corporation

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

July 22, 1991

The Honorable Christopher J. Dodd
Chairman, Subcommittee on Securities
Senate Committee on Banking, Housing and
  Urban Affairs
United States Senate

Dear Mr. Chairman:

In response to a request from the subcommittee, I am providing, for the record, GAO's views on S. 1247, the Government Securities Act Amendments of 1991, as proposed by the Department of the Treasury. The basis for my comments is GAO's 1990 report on the government securities market[1].

S. 1247, as proposed by the Department of the Treasury, makes several changes to current law. It would: (1) grant Treasury additional rulemaking powers in the area of sales practices; (2) lift the restriction that currently precludes the National Association of Securities Dealers (NASD) from adopting and enforcing government securities sales practice rules for its members; (3) grant Treasury discretionary authority to prescribe rules to ensure disclosure of and access to government securities price volume information; and (4) perpetuate Treasury's existing rulemaking authority.

In general, we agree with the major provisions of S. 1247 and believe that they reflect the recommendations we made to Congress in September 1990. My specific comments address the four provisions listed above as well as the absence of Securities Investor Protection Corporation (SIPC) insurance coverage for some government securities customers.

Sales Practice Rules and NASD Authority

As we discussed in our government securities report, there are significant disparities in abusive sales practice rules among different securities markets. In the markets for registered corporate and municipal securities, self-regulatory organizations enforce SEC-approved rules of fair dealing that supplement SEC's anti-fraud rules. These rules cover the reasonableness of price mark-ups and the suitability of a security for a particular purchaser. Such investor protection measures are missing in the government securities market. We think it inappropriate that the degree of investor protection in the government securities market be less for comparable risks than that afforded to investors in corporate securities.

---

[1] U.S. Government Securities: More Transaction Information and Investor Protection Measures are Needed, September 1990, GAO/GGD-90-114.

The biggest gap is that NASD is not permitted under the Government Securities Act to apply investor protection rules to the government securities transactions of the nearly 1,400 dealers and brokers it examines. Another concern is that while New York Stock Exchange and bank regulators say they look for abusive practices in the government securities activities of the firms they examine, the Government Securities Act does not require them to do so.

We believe that the absence of fair dealing rules (and related specific enforcement authority) makes transactions in government securities by some individuals and smaller institutional investors potentially vulnerable to abusive dealer practices. This is particularly true because in recent years securities have been developed in the government securities markets that have risk characteristics similar to those in registered markets. Examples of such securities are zero coupon bonds (whose prices are extremely sensitive to interest rate changes) and mortgage-backed securities (which are subject to cash flow variations).

While actual abuse is hard to document, there is some evidence that problems have occurred. The Government Finance Officers Association (GFOA), for example, has documented evidence of inappropriate transactions of zero coupon and mortgage-backed securities. Although there is no way to be certain, investor losses documented by GFOA might have been prevented by appropriate sales practice rules.

We believe that the provisions in S. 1247 adequately address our concerns about the current gaps in regulation of abusive sales practices. First, the proposed legislation recognizes the weaknesses in current law and gives authority to Treasury for developing and implementing rules pertaining to financial responsibility, protection of customer securities and funds, record keeping, and reporting and auditing. Second, S. 1247 also lifts the restriction placed on NASD that prohibits it from applying its sales practice rules to its members' government securities transactions. Similar recommendations were made in our government securities report.

Disclosure of Price and Volume Information

Although the government securities market is an efficient one, there is no reason to assume it is as efficient as it can be. Benefits from expanded information access, though not possible to quantify, could be reaped in three areas--market efficiency, investor protection, and equity. Market efficiency should be improved by creating a more knowledgeable group of market participants thereby fostering greater competition. From an investor protection standpoint, the availability of transaction information from the interdealer screens should make it easier for more investors to protect their interests because they will be better able to evaluate the reasonableness of the prices quoted by dealers. Markets should also become more equitable by giving non-primary dealers whose principal business is trading or investing in markets closely linked to the government securities market the information they feel is necessary to compete with primary and aspiring primary dealers in these and other markets.

In light of the unsuccessful efforts to expand information in the government securities markets on the part of private firms, we recommended that Congress mandate that government securities transaction information from screen brokers and any trading systems that serve a similar function be made available on a real time basis to those willing to pay appropriate fees. In evaluating information access arrangements we recommended that certain principles should be considered. First, broker arrangements with vendors should not be exclusive, and second, any broker participating in a joint venture should be able to make other arrangements to sell its own screen information even in competition with the joint venture.

Since we released our recommendations in September 1990, a private sector initiative has been implemented to provide additional information on the government securities markets. The GOVPX system, an industry-wide joint venture to disseminate government securities prices, implemented last month, greatly improves information access. Nevertheless, as pointed out by SEC Chairman Breeden, the current GOVPX system does not provide certain information. The system does not, for example, provide information on government securities other than Treasury obligations, and imposes limitations on the ability of users to access or store information electronically for analytical purposes. It also only provides the best bid and the offer which accompanies that bid, not the best offer itself. Consequently, while information access has certainly improved and the full range of discretionary authority provided to Treasury in S. 1247 might not be necessary, we believe that it is appropriate and advisable to provide Treasury with backstop authority to address problems with any private sector initiatives, such as GOVPX, that are developed. Such authority will help ensure that disclosure and dissemination of information is adequate. It should only be used, however, if a determination is made that information access is not sufficient. This will give the private sector the opportunity to develop and improve information access on its own, without government impediments.

Treasury Rulemaking Authority

When the Government Securities Act was adopted, Congress chose Treasury as the rulemaker primarily because of its role and expertise in a market that is so vital to the government's ability to finance the federal deficit. By choosing Treasury, Congress sought to ensure that the new regulations would not inadvertently damage the market and thereby increase the government's cost for selling the debt. Congress also anticipated that Treasury would be able to promulgate regulations that applied in an even-handed manner to both bank and non-bank securities dealers.

We believe that these concerns remain relevant today. We also believe it is better for Treasury to be in a position to consider any changes that might be needed than to have separate regulators make rules that could potentially result in different requirements for different firms. Thus, we believe it is appropriate to give lead rulemaking responsibility in the areas of regulating sales practices and information access arrangements of government securities screen brokers to Treasury for the reasons of market safety and equity that led Congress to select Treasury in the first place.

We consequently support S. 1247 in this respect but believe that Treasury's rulemaking authority should be subject to a sunset provision. Such a sunset provision was included in the Government Securities Act and has provided Congress with a useful opportunity to review the appropriateness of the rules Treasury has developed and the continued need for a separate rulemaker.

SIPC Coverage

As with sales practices, there are also disparities within the government securities market regarding insurance coverage on customer accounts. Of the approximately 1,500 registered government securities firms, only the specialist firms--which number fewer than 70--do not have some degree of insurance protection against losses in customer accounts due to fraud or failure of the dealer.

We have recommended that, in order to attain better consistency of investor protection within the government securities market, SIPC coverage should be extended to customer accounts of specialist firms. S. 1247, as proposed by Treasury, does not contain such coverage. If Congress determines that it does not want to extend coverage in this way, we believe additional disclosure requirements should be developed to reduce the possibility of investor confusion.

If you have additional questions, please do not hesitate to contact me or Stephen Swaim (202-862-3825).

Sincerely yours,

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

DEPARTMENT OF THE TREASURY
WASHINGTON

GENERAL COUNSEL

June 6, 1991

The Honorable Dan Quayle
President of the Senate
Washington, D.C. 20510

Dear Mr. President:

There are transmitted herewith a draft bill, the "Government Securities Act Amendments of 1991," and an analysis thereof. We urge expeditious consideration of the draft bill by the Senate.

The draft bill would amend section 15C of the Securities Exchange Act of 1934 (1934 Act), as added by the Government Securities Act of 1986 (GSA), to extend permanently the authority of the Secretary of the Treasury to promulgate rules and issue orders pertaining to transactions in government securities effected by government securities brokers and dealers. This authority currently is scheduled to expire on October 1, 1991.

The GSA directed the Department of the Treasury, the Securities and Exchange Commission (SEC), and the Board of Governors of the Federal Reserve System to prepare a joint report evaluating the effectiveness of regulations promulgated under authority of the GSA, including a recommendation regarding the extension of the Secretary's rulemaking authority. In a report submitted to the Congress in October 1990, the three agencies jointly recommended the extension of the Secretary's rulemaking authority.

By permanently extending the regulatory authority of the Secretary of the Treasury, the draft bill will ensure the continuity of comprehensive regulations designed to prevent fraudulent and manipulative acts and practices and protect the integrity, liquidity, and efficiency of the government securities market. Moreover, the rules preclude unfair discrimination among brokers, dealers, and customers, and avoid unnecessary burdens on competition.

The draft bill also would authorize the Secretary to promulgate sales practice rules applicable to all government securities brokers and dealers and would authorize registered securities associations, subject to SEC approval, to prescribe such rules for their members. The SEC would be required to consult with Treasury before approving or altering such rules prescribed by registered securities associations. Further, the draft bill would authorize the Secretary to promulgate rules governing disclosure of and access to government securities price and volume information. Such authorities are consistent both with a GSA-mandated report issued by the General Accounting Office in September 1990, recommending that Treasury be given these rulemaking authorities, and the regulatory structure set out in the GSA that Treasury is best situated to regulate the activities of government securities brokers and dealers.

Finally, the draft bill would make several conforming and technical amendments to the 1934 Act. These amendments are explained in detail in the enclosed analysis.

It would be appreciated if you would lay the draft bill before the Senate. An identical proposal has been transmitted to the Speaker of the House of Representatives.

The Office of Management and Budget has advised that enactment of the draft bill would be consistent with the Administration's objectives.

Sincerely,

Jeanne S. Archibald

Jeanne S. Archibald
General Counsel

Enclosures

A BILL

To amend the Securities Exchange Act of 1934 to extend the regulatory authority of the Secretary of the Treasury under the Government Securities Act of 1986, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This act may be cited as the "Government Securities Act Amendments of 1991".

SEC. 2. GOVERNMENT SECURITIES REGULATORY AUTHORITY.

(a) Extension of Rulemaking Authority.-- Section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o-5) is amended by repealing subsection (g).

(b) Additional Rulemaking Authority.-- Section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o-5) is amended in subsection (b), by redesignating paragraphs (3), (4), (5), and (6) as paragraphs (5), (6), (7), and (8) and inserting after paragraph (2) the following new paragraphs:

"(3) The Secretary may propose and adopt rules --

"(A) which define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative with respect to transactions in government securities effected by government securities brokers and government securities dealers; and

"(B) designed to promote just and equitable principles of trade with respect to transactions in government securities effected by government securities brokers or government securities dealers that are financial institutions."

"(4) In furtherance of the objective of assuring adequate dissemination of government securities price and volume information:

"(A) (i) The Secretary may propose and adopt rules and regulations designed to:

"(I) assure the prompt, accurate, reliable, and fair reporting, collection, processing, distribution, and publication of information with respect to quotations for and transactions in government securities and the fairness and usefulness of the form and content of such information;

"(II) assure that all government securities information processors may, for purposes of distribution and publication, obtain on fair and reasonable terms such information with respect to quotations for and transactions in government securities as is reported, collected, processed, or prepared for distribution or publication by any processor of such information (including self-regulatory organizations) acting in an exclusive capacity; and

"(III) assure that all government securities brokers, government securities dealers, government securities information processors, and, subject to such limitations as the Secretary, by rule, may impose as necessary or appropriate for the protection of investors or maintenance of fair and orderly markets, all other persons may obtain on terms which are not unreasonably discriminatory such information with respect to quotations for and transactions in government securities as is published or distributed.

"(ii) No self-regulatory organization, government securities information processor, government securities broker, or government securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to report, collect, process, distribute, publish, or prepare for distribution or publication any information with respect to quotations for or transactions in any government security, to assist, participate in, or coordinate the distribution or publication of such information, or to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any government security in contravention of any rules or regulations promulgated under this paragraph.

"(B) The Secretary may, by rule, as the Secretary deems necessary or appropriate in the public interest or for the protection of investors, after due consideration of any effects on the liquidity or efficiency of the government securities market, require any government securities broker or government securities dealer who has induced, attempted to induce, or effected the purchase or sale of any government security by use of the mails or any means or instrumentality of interstate commerce to report purchases, sales or quotations for any government security to a government securities information processor, national securities exchange, or registered securities association and require such a processor, exchange, or association to make appropriate distribution and publication of information with respect to such purchases, sales or quotations.".

(c) Technical Amendment.-- Section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o-5) is amended in subsection (d) by revising paragraph (2) to read as follows:

"(2) Information received by any appropriate regulatory agency, any Federal Reserve Bank, or the Secretary from or with respect to any government securities broker or government securities dealer or with respect to any person associated therewith may be made available by the Secretary, the recipient agency or the Federal Reserve Bank to the Commission, the Secretary, any appropriate regulatory agency, any self-regulatory organization, or any Federal Reserve Bank."

SEC. 3. RULES BY REGISTERED SECURITIES ASSOCIATIONS.

Section 15A(f)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3(f)(2)) is amended --

(1) in clause (E), by striking the word "and" at the end thereof;

(2) in clause (F), by striking the period at the end thereof and inserting instead ", and"; and

(3) by adding at the end thereof the following new clause:

"(G) with respect to transactions in government securities, to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade, provided such rules are consistent with any rule adopted by the Secretary of the Treasury pursuant to section 15C(b)(3)(A) of this title.".

SEC. 4. OVERSIGHT OF REGISTERED SECURITIES ASSOCIATIONS.

Section 19 of the Securities Exchange Act of 1934 (15 U.S.C. 78s) is amended --

(1) in subsection (b), by adding at the end thereof the following new paragraph:

"(5) The Commission shall consult with and consider the views of the Secretary of the Treasury (Secretary) prior to approving a proposed rule change filed by a registered securities association pursuant to section 15A(f)(2)(G) of this title, except where the Commission determines that an emergency exists requiring expeditious or summary action and publishes its reasons therefor. If the Secretary comments in writing to the Commission on such proposed rule change that has been published for comment, the Commission shall respond in writing to such written comment before approving the proposed rule change."

(2) in subsection (c), by adding at the end thereof the following new paragraph:

"(5) With respect to rules adopted pursuant to section 15A(f)(2)(G) of this title, the Commission shall consult with and consider the views of the Secretary before abrogating, adding to, and deleting from such rules, except where the Commission determines that an emergency exists requiring expeditious or summary action and publishes its reasons therefor."

SEC. 5. AMENDMENTS TO DEFINITIONS.

Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended --

(1) in paragraph 34(G) (relating to the definition of appropriate regulatory agency), by amending clauses (ii), (iii), and (iv) to read as follows:

"(ii) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System, a foreign bank, an uninsured State branch or State agency of a foreign bank, a commercial lending company owned or controlled by a foreign bank (as such terms are used in the International Banking Act of 1978), or a corporation organized or having an agreement with the Board of Governors of the Federal Reserve System pursuant to section 25 or section 25(a) of the Federal Reserve Act;

"(iii) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System or a Federal savings bank) or an insured State branch of a foreign bank (as such terms are used in the International Banking Act of 1978);

"(iv) the Director of the Office of Thrift Supervision, in the case of a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act) the deposits of which are insured by the Federal Deposit Insurance Corporation;";

(2) by amending paragraph (46) (relating to the definition of financial institution) to read as follows:

"(46) The term 'financial institution' means --

"(A) a bank (as defined in paragraph (6) of this subsection);

"(B) a foreign bank (as such term is used in the International Banking Act of 1978); and

"(C) a savings association (as defined in section 3(b) of the Federal Deposit Insurance Act) the deposits of which are insured by the Federal Deposit Insurance Corporation."; and

(3) by adding at the end thereof the following new paragraph (relating to the definition of government securities information processor):

"(53) The term 'government securities information processor' means any person engaged in the business of (i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any government security; or (ii) distributing or publishing (whether by means of a ticker tape, a communications network, a terminal display device, or otherwise) on a current and continuing basis, information with respect to such transactions or quotations. The term 'government securities information processor' does not include any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation, any self-regulatory organization, any bank, government securities broker, government securities dealer, or savings association (as defined in section 3(b) of the Federal Deposit Insurance Act), if such bank, government securities broker, government securities dealer, or association would be deemed to be a government securities information processor solely by reason of functions performed by such institutions as part of customary banking, brokerage, dealing, or association activities, or any common carrier, as defined in section 3(h) of the Communications Act of 1934, subject to the jurisdiction of the Federal Communications Commission or a State commission, as defined in section 3(t) of that Act, unless the

Commission determines that such carrier is engaged in the business of collecting, processing, or preparing for distribution or publication, information with respect to transactions in or quotations for any government security.".

GOVERNMENT SECURITIES ACT AMENDMENTS OF 1991

ANALYSIS

SECTION 1.

Short title.

SECTION 2. GOVERNMENT SECURITIES REGULATORY AUTHORITY.

Subsection (a) would repeal section 15C(g) of the Securities Exchange Act of 1934 (1934 Act). Section 15C(g), as added by section 101 of the Government Securities Act of 1986 (GSA) (Pub. L. 99-571), provides that the authority of the Secretary of the Treasury to promulgate regulations and issue orders under the GSA governing transactions in government securities by government securities brokers and dealers expires on October 1, 1991. The repeal of subsection (g) would permanently extend the regulatory authority of the Secretary. This amendment is necessary to preserve the current regulatory structure of the government securities market and to ensure continuity of regulatory policy.

Subsection (b) would amend section 15C(b) of the 1934 Act, as added by GSA section 101(b), which concerns rules adopted and implemented by the Secretary of the Treasury. This amendment would grant the Secretary of the Treasury discretionary authority to prescribe sales practice rules that are reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices for all government securities brokers and dealers, including financial institutions. Vesting Treasury with this authority would ensure that such rules provide comparable protection to customers of both bank and non-bank brokers and dealers. This amendment would also grant the Secretary discretionary authority to prescribe sales practice rules to promote just and equitable principles of trade applicable to government securities brokers and dealers that are financial institutions. These authorities, together with the granting of authority to registered securities associations (i.e., the National Association of Securities Dealers (NASD)) to prescribe just and equitable principles of trade for their members pursuant to section 15A(f)(2)(G) of the 1934 Act (as proposed herein), are intended to provide government securities investors with sales practice protections (e.g., prohibitions against excessive mark-ups, suitability guidelines, and customer authorization requirements) that are comparable to those available in other securities markets.

This subsection would also grant the Secretary discretionary authority, similar to the existing authority of the Securities and Exchange Commission (SEC) with respect to non-exempt securities transaction information, to regulate disclosure of and access to government securities price and volume information. The Secretary would be authorized:

- To assure the prompt, accurate, reliable, and fair reporting, collection, processing, distribution, and publication of government securities transaction information and the fairness and usefulness of the form and content of such information;

- To propose and adopt rules designed to assure that all government securities information processors have access, for purposes of distributing or publishing on reasonable and nondiscriminatory terms, to government securities quotation and transaction information reported, collected, processed or prepared for distribution or publication by any processor acting in an exclusive capacity regarding such information.

- To assure that all persons, including government securities brokers and dealers, and government securities information processors, as the Secretary deems appropriate, have access on reasonable and nondiscriminatory terms to quotations and transaction reports published.

This subsection also would make it unlawful for any self-regulatory organization, government securities information processor, or government securities broker or dealer to perform the functions of a government securities information processor or to purchase or sell any government security in contravention of any rules prescribed by the Secretary.

This subsection would also permit the Secretary to determine that it would be in the public interest to require the reporting of government securities quotation, purchase, or sale information by any government securities broker or government securities dealer to a government securities information processor, national securities exchange, or registered securities association, and to require recipients to make appropriate distribution and publication of the information.

Subsection (c) clarifies that information concerning any government securities broker or government securities dealer may be received from or provided to the Federal Reserve Banks as well as the Board of Governors of the Federal Reserve System.

SECTION 3. REGISTERED SECURITIES ASSOCIATIONS.

This section would amend section 15A(f)(2) of the 1934 Act, which concerns rules that registered securities associations may adopt and implement with respect to members of such associations. The amendment would grant registered securities associations (i.e., the NASD) discretionary authority to prescribe government securities sales practice rules for their members, provided such rules are consistent with sales practice rules adopted by the Secretary of the Treasury under section 15C(b)(3)(A) of the 1934 Act. In adopting sales practice rules, registered securities associations should take care not to unnecessarily impair the liquidity or efficiency of the government securities market. The provision requiring consistency parallels a provision in section 19(b)(2) of the 1934 Act which requires proposed rules of self-regulatory organizations to be consistent with the requirements of the 1934 Act and the regulations thereunder. The consistency requirement is thus intended to prevent the promulgation of any rules that would require or appear to permit government securities brokers and dealers to engage in conduct that is inconsistent with the requirements of applicable Treasury rules.

When enacted, the GSA did not rescind the restriction placed on registered securities associations that prohibits them from adopting or applying sales practice rules to government securities transactions. This amendment would rescind this restriction, and is intended to enhance customer protection by facilitating the ability of registered securities associations, specifically the NASD, to enforce compliance with sales practice rules applicable to members that are government securities brokers or dealers.

SECTION 4. OVERSIGHT OF REGISTERED SECURITIES ASSOCIATIONS.

This section would amend section 19 of the 1934 Act, which concerns registration, responsibilities, and oversight of self-regulatory organizations. This amendment would require the SEC to consult with and consider the views of the Secretary of the Treasury prior to approving government securities sales practice rules proposed by registered securities associations, specifically the NASD. The amendment would grant the SEC authority to approve such rules without consulting with Treasury if an emergency arose requiring expeditious or summary action. The amendment would also require the SEC to respond in writing to any written comment submitted by the Secretary relating to such proposed rules before it approves the rules.

Further, the amendment would require the SEC to consult with and consider the views of the Secretary before abrogating, adding to, and deleting any government securities sales practice rules developed by registered securities associations. The SEC would be able to abrogate, add to, and delete such sales practice rules without consulting with Treasury if an emergency warranted such action.

SECTION 5. AMENDMENTS TO DEFINITIONS.

Paragraph (1) would conform section 3(a)(34)(G) of the 1934 Act, as added by GSA section 102(b) (concerning the definition of "appropriate regulatory agency"), with existing bank regulatory agency supervisory authorities.

First, the Board of Governors of the Federal Reserve System (FRB) would be designated as the appropriate regulatory agency for financial institutions that are Edge or Agreement corporations. Without this modification, supervisory responsibility for the government securities activities of these entities would continue to rest with the SEC.

Since the FRB already exercises bank regulatory and supervisory responsibilities for these entities pursuant to the Federal Reserve Act, this amendment would eliminate inefficiencies and reduce costs resulting from duplicative examinations. In addition, the transfer of supervision from the SEC to the FRB is appropriate since the FRB routinely examines financial institutions, while the SEC supervises the broker and dealer activities of institutions that are not generally financial institutions.

Second, the Federal Deposit Insurance Corporation (FDIC) would be designated as the appropriate regulatory agency for insured State branches of foreign banks (the FRB would retain jurisdiction for uninsured State branches and State agencies of foreign banks). This amendment will ensure that the FDIC, which currently examines insured State branches of foreign banks pursuant to the International Banking Act, would be responsible for the examination of government securities activities conducted by such institutions. The amendment would eliminate the costs associated with duplicative examinations.

Finally, as a technical amendment, this provision would insert a parenthetical reference to the definition of "savings association" contained in the Federal Deposit Insurance Act. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) amended clause (iv) to designate the Director of the Office of Thrift Supervision (OTS) as the appropriate regulator for savings associations. The term "savings association," however, is not defined in the Act.

Paragraph (2) would technically amend the definition of "financial institution" contained in section 3(a)(46) of the 1934 Act. Prior to FIRREA, section 3(a)(46) referenced the definition of "insured institutions" (including insured thrifts) contained in the National Housing Act (NHA). FIRREA, however, repealed the referenced NHA definition. The amendment would clarify the definition of "financial institution" by reincluding entities that were formerly insured by the Federal Savings and Loan Insurance Corporation. Consistent with FIRREA section 744(u), this provision would include savings associations insured by the FDIC and subject to supervision by the OTS within the definition of "financial institution."

Paragraph (3) would add to section 3(a) of the 1934 Act a definition of the term "government securities information processor." The term is based on the definition of a "securities information processor" found at section 3(a)(22)(A) of the 1934 Act and is defined as any person engaged in the business of collecting, processing, or preparing for distribution or publication information with respect to transactions in or quotations for any government security and also any person engaged in distributing or publishing such information on a current and continuing basis. The press and common carriers subject to the jurisdiction of the Federal Communications Commission or a State commission, would be exempted from the definition unless such carrier is engaged in the business of preparing for or coordinating the distribution or publication of such information. Self-regulatory organizations would also be exempt from the definition, as would banks, government securities brokers, government securities dealers, or savings associations if the latter four organization types would be government securities information processors merely because they engage in functions customary for such institutions.

DEPARTMENT OF THE TREASURY
WASHINGTON

April 1, 1991

The Honorable Christopher J. Dodd
Chairman
Securities Subcommittee
Committee on Banking, Housing
  and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Mr. Chairman:

I am replying to your letter of December 10, 1990, requesting the Treasury Department's views on legislation to extend and otherwise amend the Secretary's rulemaking authority under the Government Securities Act of 1986 (GSA).

As you know, in the joint Study of the Effectiveness of the Implementation of the Government Securities Act of 1986, published in October 1990, the Treasury, Securities and Exchange Commission (SEC), and Board of Governors of the Federal Reserve System recommended that Treasury's rulemaking authority be extended. The joint study states that Treasury is in the best position to act as the Federal agency overseeing the government securities market, because Treasury has a comprehensive understanding of the market and, as an issuer, is concerned both with maintaining market integrity and with minimizing the government's cost of borrowing. In addition, Treasury as the single rulemaker can assure that appropriate regulations are in place for all market participants, including financial institutions. Accordingly, we recommend that Congress extend Treasury's rulemaking authority by deleting the sunset provision contained in the GSA.

You have asked for Treasury's positions on potential amendments to the GSA in three areas recommended by the General Accounting Office (GAO) in its study entitled U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed, published in September 1990.

1. Sales Practice Rules

In its report, the GAO recommended that Congress assign Treasury new authority to promulgate sales practice rules applicable to all government securities brokers and dealers. We concur with the GAO and recommend that Treasury be authorized to promulgate sales practice rules, as determined necessary by the Secretary, for any entity that has registered with the SEC as a government securities broker or dealer or given notice to the SEC or to a Federal financial institution regulator that it is a government securities broker or dealer.

The government securities market is the only regulated securities market in the United States that does not have rules prohibiting abusive sales practices. As stated by the GAO, sales practice rules have become a fixture in the securities markets in the United States. Such rules are in place in the corporate and municipal securities markets, but currently, sales practice rules are not imposed for the vast majority of transactions in government securities. Given the potential for similar types of abuses in these three markets, application of sales practice rules to the government securities market would provide comparability with the corporate and municipal markets.

Granting Treasury rulemaking authority for sales practices would be consistent with the regulatory structure set out in the GSA. Congress originally chose Treasury as sole rulemaker due to its expertise in the market, its interest in minimizing the government's cost of borrowing, and its ability to provide balanced regulatory treatment among the various market participants. This regulatory approach would continue to recognize Treasury's knowledge of the market and its responsibility, as the largest issuer, to ensure that any sales practice rules, while strengthening customer protection, would not impair the liquidity or efficiency of the market or increase the cost of financing the public debt. Additionally, vesting such authority with Treasury would ensure that sales practice rules would provide comparable protection to customers of both bank and non-bank broker-dealers.

2. Access to Pricing Information

We propose that Congress enact legislation granting the Secretary of the Treasury discretionary authority to develop regulations, as necessary, to ensure disclosure of and access to government securities price and volume information. Expanded availability of such information would serve the public interest, because it would ensure that a broad spectrum of market participants could obtain current, accurate facts about market conditions and, thus, the competitiveness of the market would improve. Moreover, expanded information access would serve to enhance investor protection, since investors would be in a better position to determine appropriate prices for securities.

Treasury fully supports the efforts undertaken by the Public Securities Association and its members in developing a system to disseminate government securities price information. The system -- which has been named GOVPX, Inc. -- will provide real-time information on some government securities that will be made available to the public. We believe that the establishment of GOVPX was significantly influenced by the growing pressure for a federal regulatory presence in this area. Accordingly, federal regulatory authority is desirable to encourage further expansion of fair and reasonable access to government securities price information even though it might not be necessary to use this authority.

3. Extension of Securities Investor Protection Corporation (SIPC) Insurance Coverage

The Treasury does not take any position with regard to whether SIPC insurance should be extended to customers of all government securities brokers and dealers. We would be glad to work with the Committee, SIPC, and other interested parties to determine whether extension of SIPC coverage is desirable.

In addition to the three areas discussed above, we recommend technical amendments to the GSA to amend the definition of "appropriate regulatory agency" to make supervisory responsibilities under the GSA consistent with existing bank regulatory agency supervisory responsibilities regarding certain financial institutions that are government securities brokers or dealers. Technical amendments are also necessary to revise the definitions of "appropriate regulatory agency" and "financial institution" to respond to changes in nomenclature under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

With regard to compliance with the GSA regulations, the evidence included in the joint report shows that there has been a high degree of compliance with the regulations. We do not believe that there are any areas of material weakness in the regulations. While instances of noncompliance have been for the most part easily correctable, our study did conclude that the wide variance in the levels of examination and dissemination of information by the appropriate regulatory agencies has been an area of concern. Frequent, regular examinations of brokers and dealers are necessary to ensure that the goals of the GSA are met.

We plan to submit draft legislation soon to amend the GSA and look forward to working with the Committee in connection with this important legislative initiative.

Sincerely,

Robert Glauber

Robert R. Glauber
Under Secretary (Finance)

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

March 6, 1991

The Honorable Christopher Dodd
Chairman
Subcommittee on Securities
Committee on Banking, Housing, and
  Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of December 10 requesting the Board's views on the need for new legislation to safeguard investor interests in the government securities market. The Board of Governors continues to support the recommendations of the joint Treasury-SEC-Board study--most importantly, that Congress extend Treasury's rulemaking authority over the market beyond the current sunset date--but it views the rationale for additional legislation as less compelling.

In approaching this issue, the Board begins from the premise that it is essential to preserve the extraordinary liquidity and efficiency of the government securities market. This liquidity both facilitates the implementation of monetary policy through open market operations and allows the Treasury to issue federal debt at the lowest possible cost to the taxpayers.

Any securities regulation involves costs--directly to the issuer, customer, or dealer, as well as indirectly by affecting the general liquidity of the market. Consequently, in weighing the advisability of added regulation, the Congress will, of course, want to assure itself that the expected benefits of any new regulation exceed the associated expected costs. Several years ago, when drafting the Government Securities Act, the Congress explicitly considered the case for broader regulation, but chose not to make it part of the Act. In the Board's view, a convincing case for calling this decision into question has not yet been made.

In the area of sales practice rules the General Accounting Office's report in September 1990 recommended that the Congress amend the Securities Exchange Act to authorize a federal agency to adopt rules of fair practice applicable to all government securities brokers and dealers, addressing, at a minimum, dealer markups and investor suitability requirements. Our experience in applying markup regulations elsewhere suggests that there are significant difficulties and ambiguities in administering the rules fairly. Even if judgments about the reasonableness of markups in this fast-paced market could be made on an ex-post basis, it could be difficult to formulate meaningful criteria for use in making ex-ante judgments and providing guidance to dealers. Similarly, the Board is concerned that suitability rules could impose a burden on the government securities market, by adding to costs or perhaps even delaying the execution of transactions. At the same time, the losses in the government securities market cited by the GAO and others in support of sales practice rules generally have involved large investors, whom one might expect to have the sophistication to judge the appropriateness of various investments themselves. Thus, it is unlikely that these losses would have been prevented by suitability rules. In the absence of clear evidence that suitability requirements are necessary to protect participants in the government securities market, the Board is not convinced that such rules would be a helpful addition to this market.

With respect to the GAO recommendation that Securities Investor Protection Corporation (SIPC) insurance be extended to customer accounts at registered government securities brokers and dealers, there could be some marginal benefits in terms of customer protection, but other regulatory changes might be necessary in connection with the adoption of this proposal. For example, SIPC has pointed out that the proposal raises major questions about regulatory oversight, because all current members of SIPC are subject to the full rulemaking authority of the SEC. A range of related questions warrants further study before a definitive conclusion can emerge about the desirability of expanding SIPC coverage.

The issue of whether legislation is needed to expand access to information about securities trading through interdealer brokers appears to be very nearly moot. An independent corporation sponsored by the Public Securities Association and owned by the brokers and dealers plans to begin disseminating price and volume information on a fee basis soon. We recognize that this effort may have been motivated strongly by the possibility of legislative action. Nevertheless, we believe that so long as it is going forward, actual legislation and associated regulatory oversight are unnecessary and could actually constrain rapidly changing market practices.

Finally, on the issue of examination frequency, it is clear that a meaningful examination program is essential to implement effective regulatory oversight. The Federal Reserve System examines the government securities activities of State member banks as part of regularly scheduled bank examinations. As a general matter, it is our policy that every State member bank be examined at least annually by the Federal Reserve or by a State banking agency under a supervisory agreement with the Federal Reserve. Thus far, compliance with the Treasury's regulations appears to have been generally good. Most violations cited have been fairly minor and easily correctable; when violations have been brought to the attention of bank staff, immediate action has been taken to correct problems.

In sum, by instituting an effective and comprehensive regulatory structure, the Government Securities Act of 1986 appears to have largely accomplished its goals. It is the Board's position that the need for additional legislation, beyond that already proposed in the joint Treasury-SEC-Board study, has not been demonstrated. Please let me know if I can be of further assistance.

Sincerely,

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

February 26, 1991

The Honorable Christopher J. Dodd
Chairman
Securities Subcommittee
Committee on Banking, Housing, and
  Urban Affairs, United States Senate
SD-535 Dirksen Senate Office Bldg.
Washington, DC 20515

Dear Chairman Dodd:

Thank you for the opportunity to comment on the proposals made by the General Accounting Office ("GAO") concerning regulation of the government securities market and on whether there is a need for amendments to the Government Securities Act of 1986 in addition to those recommended jointly by the Department of the Treasury, Securities and Exchange Commission, and the Board of Governors of the Federal Reserve System in the Study of the Effectiveness of the Implementation of the Government Securities Act of 1986.

As set forth more fully in the attached report, which discusses the recommendations of the GAO in detail, the Commission believes that there is a need for greater transparency in the market for government securities than there has been. In our view, there should be broad access to real-time pricing information from all government securities brokers and government securities dealers. This information should include both transaction information, including price and volume, and quotation information. Increased information access would enhance the ability of investors to evaluate the fairness of executions proposed by primary and aspiring primary dealers, who currently have exclusive access to the most comprehensive pricing information. Increased access would also increase the confidence of both public and private investors in the pricing efficiency of this key market.

The Honorable Christopher J. Dodd
Page 2

We look forward to working with you on amending the Government Securities Act of 1986 and would be happy to provide assistance to the Committee in preparing legislation.

Sincerely,

Richard C. Breeden
Chairman

Enclosure

(Similar letter sent to
The Honorable John Heinz)

RESPONSE OF THE SECURITIES AND EXCHANGE COMMISSION TO REQUEST OF CHAIRMAN DODD AND SENATOR HEINZ OF THE SENATE SECURITIES SUBCOMMITTEE CONCERNING THE GENERAL ACCOUNTING OFFICE RECOMMENDATIONS FOR AMENDING THE GOVERNMENT SECURITIES ACT OF 1986

The General Accounting Office Report entitled U.S. Government Securities: More Transaction Information and Investor Protection Measures are Needed (September 1990) ("GAO Report" or "Report") analyzes two kinds of issues: issues relating to the need for Congress to mandate additional regulation of the government securities market (i.e., substantive issues) and questions regarding the proper federal agency or self-regulatory organization ("SRO") to carry out such regulatory mandates (i.e., authority issues).

With respect to the substantive issues, the GAO Report recommends that Congress amend the Securities Exchange Act of 1934 ("Act") to: (1) require that government securities interdealer brokers make transaction information available to any participant in the government securities market willing to pay the appropriate fees; 1/ (2) authorize the adoption and enforcement of additional rules governing the sales practices of government securities brokers and dealers, especially in the areas of markups, unsuitable transactions, and churning, as well as advertising by government securities brokers and dealers that are banks; and (3) require that insurance coverage provided by the Securities Investor Protection Corporation ("SIPC") be extended to customer accounts held by non-bank "specialized" government securities brokers and dealers 2/ not now subject to

---

1/ The Report does not recommend, however, that interdealer brokers be compelled at this time to expand access to their screen-based trading services to market participants other than primary and aspiring primary dealers.

2/ "Specialized" government securities brokers and dealers limit their business to effecting transactions in U.S. government securities and other exempt securities (except municipal securities) (see Section 3(a)(12) of the Act, 15 U.S.C. 78c(a)(12)). They are required under the Government Securities Act of 1986 ("GSA") to register with the Commission pursuant to Section 15C of the Act, 15 U.S.C. 78o-5. "Diversified" government securities brokers and dealers effect securities transactions both in exempt and non-exempt securities. They are required under the GSA to notify their appropriate regulatory agencies (see Section 3(a)(34) of the Act, 15 U.S.C. 78c(a)(34)) of their government securities activities.

the Securities Investor Protection Act of 1970 ("SIPA"), 3/ and that the SIPC assessment structure be modified to ensure that these specialized brokers and dealers carry their fair share of the assessment burden.

With respect to the authority issues, GAO recommends that Congress authorize the Secretary of the Treasury ("Treasury") to promulgate rules governing the dissemination of, and access to, transaction information disseminated by interdealer brokers. GAO also recommends that the scope of Treasury's rulemaking authority be expanded to encompass the authority to adopt federal sales practice rules, including benchmarks for determining excessive markups, and that the National Association of Securities Dealers ("NASD") be authorized to promulgate and enforce rules setting forth just and equitable principles of trade with respect to its members' transactions in government securities.

Subject to a limited number of qualifications noted below, the Commission agrees with GAO's views on the substantive issue of dissemination of pricing information. With respect to the GAO's recommendation for expanded sales practice authority, we share GAO's concerns, but have not seen sufficient evidence of abuse to recommend a change at this time. With respect to the GAO's recommendation that SIPC insurance coverage be extended to customer accounts held by specialized government securities brokers and dealers, we believe that a necessary pre-condition to SIPC membership for specialized government securities brokers and dealers is the elimination of all restrictions on the NASD's rulemaking authority over transactions in exempted securities, 4/ other than municipal securities. This would permit the NASD to apply existing financial responsibility rules, such as the fidelity bonding and maintenance margin rules, as well as adopt appropriate qualification requirements, such as requirements for testing of financial and operational principals.

The Commission also would address the authority issues somewhat differently than the GAO recommends. In particular, the Commission believes that, if Congress determines to provide sales practice and additional SIPC protection to customers in this market, it would be desirable to expand the NASD's authority, (subject to Commission oversight) 5/ to encompass all of its

---

3/ 15 U.S.C. 78aaa *et seq*.

4/ Under Section 15A(f)(2) of the Act, the NASD is prohibited from adopting general rules applicable to transactions of its members in exempted securities.

5/ The Commission currently has examination, oversight and rule approval authority over all aspects of NASD operations.
(continued...)

members' transactions in exempted securities, except municipal securities, (for which rulemaking responsibility is assigned to the Municipal Securities Rulemaking Board ("MSRB")). We also believe that the Commission, like Treasury, is well suited to exercise much of the additional authority that GAO recommended be assigned to Treasury. The Commission's specific views are discussed below. 6/

I. Substantive Issues

A. Access to Real-Time Transaction and Quotation Information

As noted above, the GAO Report recommends that Congress amend the Act to require that government securities interdealer brokers make transaction (i.e., last-sale) information available, by a date certain, to any participant in the government securities market willing to pay the appropriate fees. This recommendation mirrors the longstanding views of the Commission in this regard.

Nearly three years ago the GAO, in its report entitled U.S. Government Securities, An Examination of Views Expressed about Access to Brokers' Services ("1987 Report"), concluded that it would be desirable and in the public interest to expand access to

---

5/(...continued)
See, e.g., Sections 17(b), 19(b), 19(c), 19(g) and 19(h) of the Act, 15 U.S.C. 78q(b), 78s(b), 78s(c), 78s(g) and 78s(h). Any expansion of NASD rulemaking authority relating to government securities should provide for Commission oversight of that rulemaking.

6/ Consistent with the positions taken by the GAO and the Commission, the Study of the Effectiveness of the Implementation of the Government Securities Act of 1986 (October 1990) ("Joint Report"), prepared jointly by the Commission, Treasury, and the Board of Governors of the Federal Reserve System ("FRB"), recommends that Treasury's existing rulemaking authority be extended beyond the current sunset date. The Joint Report does not take a position, however, on the proposals of the GAO and the Commission to amend the Act to require that pricing information be made more broadly available to the public; nor does it take a position on proposals of the GAO to: (1) authorize the adoption and implementation of federal sales practice rules; and (2) require that non-bank, "specialized" government securities brokers be required to become members of SIPC.

both transaction and quotation information. 7/ The 1987 Report, however, suggested that the participants in the government securities market should be given the opportunity to make the arrangements necessary to accomplish this expansion of access before regulatory intervention was pursued. 8/ In its comment letter 9/ to GAO on the 1987 Report, the Commission agreed with the GAO's conclusion that expanded access would be in the public interest; however, the Commission disagreed with the conclusion that interdealer brokers, with the acquiescence of the primary dealers, necessarily would achieve this result voluntarily. Accordingly, the Commission concluded that resistance to information dissemination among primary dealers, coupled with potential issues concerning the possible proprietary nature of transaction and quotation information, mitigated against reliance on voluntary action by the interdealer brokers and primary dealers to achieve this result. 10/

The recently published GAO Report, in affirming the importance of amending the Act to mandate expansion of access, conforms to the previously stated views of the Commission. The Report notes that, in the period of nearly three years since the GAO published its 1987 Report, little progress has been made among government securities brokers and dealers in increasing access to transaction information. Indeed, the Report contains a description of several efforts by interdealer brokers to provide greater access to information in their possession and also explains that those efforts have been unsuccessful. The Report further states that the skepticism expressed by the Commission in 1987 about the willingness of primary dealers to cooperate voluntarily with efforts to expand access appears justified, and that the potential for dealer resistance to such efforts may continue to inhibit future initiatives to expand information access. In light of the failure of these private sector initiatives and the potential for continued dealer resistance, the GAO concludes that federal regulation is necessary and appropriate.

7/ 1987 Report, at 73. We note that the GAO's 1987 recommendation of expanded access applied to both transaction and quotation information; its more recent recommendation applies to transaction information only.

8/ 1987 Report, at 76.

9/ Letter from Richard G. Ketchum, Director, Division of Market Regulation, SEC, to William J. Anderson, Assistant Comptroller General, GAO (May 22, 1987) ("Comment Letter").

10/ Comment Letter, at 9-10.

The Commission concurs with GAO's recommendation that Congress mandate the expansion, by a date certain, of access to pricing information. As the Joint Report concluded, "[r]elease of price information should enhance the ability of customers to judge actual or potential transaction prices in the market, especially for inactively traded issues." 11/

The Commission believes that broader access to pricing information will serve important policy objectives. First, we believe that it is critical that retail and institutional investors have a reliable means to assess objectively the quality of executions proposed to be given them by the primary dealer community. In evaluating an ask price quoted by a primary dealer, it is important, for example, that an institutional money manager be able to compare that quoted price with the price at which the primary dealer is willing to sell that security to other primary dealers, in order to assess whether the proposed execution bears a reasonable relationship to the prevailing interdealer market price. Increased information access will enhance the ability of retail investors to evaluate the fairness of executions proposed by the primary and aspiring primary dealers. 12/ Second, the availability of more complete pricing information will enhance fair competition among primary and secondary dealers. Accessibility of accurate and complete quotation and transaction information will enhance the ability of secondary dealers to quote competitive markets. Third, options and futures traders, both exchange-based and over-the-counter ("OTC"), depend upon the timeliness and accuracy of pricing information on the underlying securities for their trading and hedging strategies. The inability of such traders to ascertain the correct price of the underlying securities may inhibit their willingness to take large positions and effectively widen bid-ask spreads in the derivative markets. Accordingly, we believe that improved information access will increase the willingness of options and futures traders to take substantial positions, and may also serve to narrow spreads, thus improving the quality of the derivative markets. Finally, the availability of accurate information on completed trades and dealer quotations enhances pricing efficiency, e.g., the relationship between a quoted price and the actual value of the security as reflected in an active secondary market. The willingness of both institutional and non-

---

11/ Joint Report, at 87.

12/ Although the antifraud provisions of the federal securities laws would continue to be applicable to government securities transactions and would protect investors against fraudulent, excessive, undisclosed markups, they are not substitutes for wider dissemination of market information, which should improve market knowledge in all transactions (including those where reasonable markups are charged).

institutional investors to participate actively in a given market generally increases as those investors develop greater confidence in the pricing efficiency of that market.

The Commission believes that these benefits could be obtained without diminishing market liquidity. Given the high level of volume in the government securities market, the Commission perceives no likelihood that accurate last-sale or quotation information would increase significantly the risks borne by dealers taking substantial positions. The government securities market, in contrast to the corporate debt market, is an extremely liquid and active market. It is properly characterized as the most liquid securities market in the world, and as such, access to trade and quote information is vital to market participants. Participants with access to information have first-hand knowledge of the "market"; those without such access must rely on second or third-hand information. In the government securities market, where liquidity surpasses the liquidity of the equity securities market, we see no reason for continuing to limit the distribution of trade and quote information.

Despite this view that more information would improve pricing efficiency and investor protection, an operational information dissemination system has yet to be developed. In recent months, however, one project has been initiated that may lead to expanded information access. The Public Securities Association ("PSA"), on January 16, 1991, announced that a joint venture of primary dealers and interdealer brokers has established a system called GOVPX, Inc. ("GOVPX"), that will, beginning March 1991, provide real-time price and quotation information on all U.S. Treasury bills, notes, and bonds, on a 24-hour basis, to on-line vendors for redistribution to the public. 13/ GOVPX will disseminate price and quotation information to vendors through a network feed that will present in video display format a composite picture of dealer activity showing executed trade prices, volume of executed trades, best bid quotations, and the offer quotations accompanying those best bids, yields, and running aggregated volumes traded in each security on a daily basis. The PSA initiative does not offer as much pricing information as the interdealer brokers' screens. For example, the quotation information disseminated by GOVPX does

---

13/ Another private initiative has been undertaken by Electronic Joint Venture Partners LP ("EJV"). EJV has purchased the so-called "CHATS" system from Chapdelaine & Co., an interdealer broker. CHATS is an electronic system designed to permit primary dealers to communicate, to their interdealer brokers, their desire to purchase or sell by making a computer entry instead of contacting the broker by telephone.

not include the size associated with published bids and offers nor does it include the best bid and best offer for a particular security, but rather the best bid and the offer that accompanies that bid. Thus, an investor seeking to sell a security to a primary or aspiring primary dealer would necessarily see the best bid quotation in the primary dealer market; however, an investor seeking to buy from a primary dealer would not necessarily see the best ask quotation in that market.

We applaud and welcome the PSA initiative, and we believe that it ultimately may succeed in facilitating the broader information dissemination that we seek. At a threshold level, however, it is legitimate to question whether the PSA would have pursued this initiative absent the continued review of the GAO and its findings that strong public policy interests favor dissemination of real-time pricing information to investors outside of the primary dealer community. Moreover, even assuming the PSA's plan is effectively implemented, the resulting dissemination of information will not be as complete as information available to primary and aspiring primary dealers through the interdealer brokers' screens. For example, as discussed above, GOVPX does not intend to make the best ask quotation available to the subscribers to the service. Furthermore, the PSA initiative does not include information for all government securities brokers and dealers. 14/

Accordingly, although the PSA initiative and others like it ultimately may obviate the need for government intervention, we believe it is advisable that Congress set forth, as a backstop to current private sector efforts in this area, a framework of federal regulation to ensure that the public policy objectives cited above are attained. 15/ As more fully discussed in Part II, we believe there are good arguments for giving either Treasury or the Commission the authority to implement such a regulatory regime.

14/ Without legislation, there also can be no assurance that other potential systems can be integrated with GOVPX so that vendors of securities information and investors can be assured of achieving full market transparency on a consolidated basis.

15/ With respect, however, to the additional question of whether access to the anonymous trading services offered by interdealer brokers should be expanded to include market participants other than primary and aspiring primary dealers (see GAO Report, at 66-74), the Commission believes that regulation mandating such expanded access is not warranted at this time.

Finally, the Commission believes that any legislatively imposed requirement that information access be expanded should encompass not only the transaction information called for by GAO, but also real-time quotation information. In addition, any such legislation should include authority to require that government securities dealers, in addition to interdealer brokers, provide market data. Legislation that, when implemented, requires only interdealer brokers to provide access to market information could create an incentive for primary dealers to discontinue using the services of interdealer brokers, resulting in the same informational problems that exist today.

B. *The Need for Additional Rules Governing Sales Practices*

The GAO Report recommends that Congress authorize the adoption and enforcement of additional rules governing sales practices in the government securities market, 16/ and that the government securities activities of banks, especially advertising, be subject to regulatory oversight comparable to that currently accorded non-bank securities firms. 17/

Sales practice rules adopted by self-regulatory organizations ("SROs") require adherence to the "high standards of commercial honor and just and equitable principles of trade" that those SROs believe should guide the conduct of their members. 18/ Those sales practice rules embody more specific standards of conduct than the antifraud rules promulgated by the Commission under Section 10(b) of the Exchange Act. 19/ Enforcement of sales practice rules by the SROs, unlike enforcement of Commission antifraud rules, generally requires no explicit showing that the respondent acted with scienter, or intent to defraud. 20/ For example, a sales practice rule

---

16/ In this connection, the Report urges that Congress amend the Act to: (1) authorize Treasury to promulgate federal sales practice rules; and (2) expand the NASD's authority to promulgate and enforce rules to promote just and equitable principles of trade in the sales practice area.

17/ In this regard, the Report recommends that the Commission, Treasury, and the FRB develop recommendations to ensure this regulatory comparability. Report, at 44.

18/ *See* Article III, Section 1 of the NASD's Rules of Fair Practice, *NASD Manual* ¶ 2151, at 2013-3.

19/ 15 U.S.C. 78j(b).

20/ *See, e.g.*, *In re Eugene J. Erdos*, 47 S.E.C. 985 (1983), *aff'd*, 742 F.2d 507 (9th Cir. 1984) (showing of scienter not (continued...)

adopted by the NASD -- Article III, Section 4 of the NASD's Rules of Fair Practice (the NASD's "markup rule") -- requires that a member engaging in a principal transaction "buy or sell at a price that is fair . . . ." 21/ Commission Rule 10b-5 under the Act, on the other hand, which also serves as a basis for prosecuting excessive markups, 22/ more generally prohibits any person from employing "any device, scheme, or artifice to defraud." 23/ The NASD may prosecute a violation of its markup sales practice rule without showing that respondent failed to disclose that the amount of the markup charged was fraudulent, and without showing that respondent acted with scienter; on the other hand, successful prosecution of a markup violation under Commission Rule 10b-5 requires both showings. 24/ Accordingly, because SRO sales practice rules may embody more specific and

---

20/(...continued)
required in order to establish that respondent broker-dealer violated Article III, Section 2 of the NASD's Rules of Fair Practice, prohibiting excessive trading in a customer's account).

The term "scienter," as applied to conduct necessary to give rise to an action for civil damages under the Exchange Act and Rule 10b-5, refers to a mental state embracing intent to deceive, manipulate, or defraud. Ernst and Ernst v. Hochfelder, 425 U.S. 185 (1976). Most courts have followed the standard in Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir. 1977), which describes the necessary mental state as encompassing "recklessness", i.e., one in which "the danger of misleading buyers must actually be known or so obvious that any reasonable person would be legally bound as knowing. . . .' Id. at 1045. In other circuits, see Hollinger v. Titan Capital Corp. & Co., 914 F.2d 1564 (9th Cir. 1990) (en banc); Warren v. Reserve Fund, Inc., 728 F.2d 741, 745 (5th Cir. 1984); Kennedy v. Tallant, 710 F.2d 711, 720 (11th Cir. 1983); Hackbart v. Holmes, 675 F.2d 1114, 1117 (10th Cir. 1982); Sharp v. Coopers & Lybrand, 649 F.2d 175, 193 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982); Mansbach v. Prescott Ball & Turben, 598 F.2d 1017, 1023-25 (6th Cir. 1979).

21/ NASD Manual, ¶ 2154, at 2055.

22/ See, e.g., Ettinger v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 835 F.2d 1031, 1033 (3d Cir. 1987).

23/ 17 C.F.R. § 240.10b-5(a).

24/ See Charles Hughes & Co. v. SEC, 139 F.2d 434, 436-438 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1943); Ernst and Ernst v. Hochfelder, 425 U.S. 185 (1976).

stringent Commission-approved standards of conduct than Commission antifraud rules, and require a lower threshold showing in order to prove a violation, Commission-approved SRO sales practice rules generally are considered to be an important and flexible tool in the prosecution of abusive market practices.

The Report correctly states that sales practice rules already in place apply to the government securities activities of *some* participants in the government market. Specifically, sales practice rules promulgated by the New York Stock Exchange ("NYSE") and other national securities exchanges apply to the government securities activities of the members of those exchanges. 25/ On the other hand, financial institutions and members of the NASD are not generally subject to any sales practice rules to the extent those financial institutions and NASD members carry on a government securities business. 26/ Rather, they generally are subject only to the antifraud

---

25/ Registered brokers or dealers that have filed notice as government securities brokers or dealers and that are members of the NYSE or other national securities exchanges are subject to exchange sales practice rules. Specifically, the NYSE's "know your customer" requirement has been interpreted by the NYSE and courts to impose a suitability requirement. In addition, although the exchanges have not adopted rules specifically proscribing excessive prices, the exchanges may nonetheless prosecute such violations under more general rules designed to enforce adherence to just and equitable principles of trade. For example, the NYSE could allege that a member's charging excessive commissions violated NYSE Rule 401, entitled "Conduct of Accounts," that requires that every member "adhere to the principles of good business practice in the conduct of his or its business affairs." *New York Stock Exchange Guide*, ¶ 2401, at 3695 (February 1989).

26/ To the limited extent financial institutions and NASD members are subject to sales practice regulation with respect to their government securities business, they are subject to unequal degrees of such regulation. NASD members are subject to the NASD's rules prohibiting false and misleading advertising (*see* NASD Government Securities Rules, *infra* note 56, Section 8, *NASD Manual* ¶ 2428, at 2267-71); financial institutions are not subject to advertising rules. With respect to financial institutions, the Office of the Comptroller of the Currency ("OCC") applies the non-advertising sales practice rules adopted by the MSRB as benchmarks for the government securities transactions of national banks. Joint Report, at 79; *see also*, MSRB Rule G-17. NASD members are not subject to such rules.

provisions of the federal securities laws, primarily Rule 10b-5 under the Act. 27/

The NASD has requested expansion of its authority to promulgate and enforce rules of fair practice in the government securities area. 28/ It argues that such authority would relieve investigative and litigation burdens currently imposed by the need to proceed under Commission rules -- particularly Rule 10b-5. Notwithstanding the benefits of sales practice rules, in 1986 Congress concluded that the cost of new sales practice rules specifically applicable to government securities exceeded the benefits. 29/ There have been relatively few abuses, 30/ the market is primarily institutional, 31/ and the Commission's antifraud rules remain applicable to abusive sales practices. The Commission believes market abuses most often involve the sale of unusual products, such as zero-coupon Treasury bonds (bonds sold at a discount because they do not pay interest to the holder prior to maturity), 32/ and derivative instruments, such as

---

27/ 17 C.F.R. § 240.10b-5.

28/ See Report, at 50, note 6, citing letter from Joseph R. Hardiman, President, NASD to Robert Glauber, Under Secretary for Finance, Department of Treasury, dated March 3, 1989.

29/ See S. Rep. No. 426, 99th Cong., 2d Sess. 10, 13-14, 16 and 20. See also Joint Report at 78-84.

30/ In the last three fiscal years, the NASD has brought 13 disciplinary actions against 11 firms and/or individuals associated with those firms for sales practice abuses involving government securities or options on government securities that are exempted pursuant to Rule 3a12-7, 17 C.F.R. § 240.3a12-7.

31/ As of the second quarter of 1990, there was over $3.5 trillion in government securities outstanding. This figure, the latest available, includes the debt of the U.S. Treasury and federal and federally-sponsored agencies. Federal Reserve Bulletin (October 1990), Tables 1.41, 1.44. As of the first quarter of 1990, individuals and state and local governments owned 7% and 11%, respectively, of Treasury debt outstanding. These proportions have not changed significantly in the last three years. Id. at Table 1.41. Data on ownership of federal and federally-sponsored agency securities are not readily available.

32/ See In re PaineWebber Incorporated, Securities Exchange Act Release No. 25418 (March 4, 1988). In this administrative proceeding PaineWebber was censured for charging customers (continued...)

forward contracts on Government National Mortgage Association ("GNMA") certificates accompanied by so-called "stand by" agreements to repurchase the certificate on the date of settlement. 33/ Although the imposition of more stringent standards embodied in sales practice rules might have proven effective in deterring abuse in those areas, we have not seen changes in the market that would warrant our recommendation to overturn so recent a Congressional decision as to the proper scope of regulatory authority in this market.

32/(...continued) undisclosed excessive markups and markdowns on sales of stripped U.S. Treasury bond coupons.

Cf. the Brief of the Securities and Exchange Commission, Amicus Curiae, Elysian Federal Savings Bank v. First Interregional Equity Corp., No. 88 Civ. 3528 (D.N.J. 1989), where the plaintiff alleged that the defendants committed fraud by charging excessive markups in the sale of Federal Home Loan Mortgage Corporation ("Freddie Mac") collateralized mortgage obligations ("CMOs"), which were general obligations of Freddie Mac collateralized by mortgage loans acquired by Freddie Mac, and Federal National Mortgage Association ("Fannie Mae") principal-only trust certificates ("POs") in which Fannie Mae has agreed to pay the PO certificate holder on a monthly basis all scheduled principal payments collateralized by a pool of Fannie Mae guaranteed mortgage pass-through certificates, which represent beneficial interests in pools of fixed-rate residential mortgage loans, and to pass through all principal prepayments thereon.

33/ See SEC v. G. Weeks Securities, Inc., Civil Action No. 79-2711-G (W.D. Tenn.), Litigation Release No. 11403 (April 15, 1987). The defendant was enjoined from selling "standby with pair-off" investment contracts without registration under Sections 5(a) and 5(c) of the Securities Act of 1933. The defendant sold customers a "forward contract" for the delivery of a GNMA certificate at a specified future date for a price determined at the time the contract was written. Payment from the customer for this purchase was not due until the settlement date. At the same time, the defendant agreed to "stand by" to repurchase the GNMA certificate from the customer on the settlement date at a stated higher price. The customer paid the defendant a "commitment fee" when he effected a "standby with pair-off" transaction. The spread between the price charged the customer and the higher standby price, fixed by the defendant in his role as a trader, was sufficient to yield the customer an amount equal to his commitment fee plus a fixed profit expressed as a rate of return.

C. The Need For Expanding Required SIPC Coverage

In its Report, the GAO recommends that: (1) Congress amend the Act to require that all non-bank specialized government securities dealers "provide SIPC coverage if their business with customers is similar to that for which SIPC coverage normally applies in SEC-registered securities markets;" and (2) SIPC's assessment structure be modified "so that speciali[zed] firms covered by SIPC pay their fair share of the assessment burden." 34/

Under Section 3(a)(2)(A) of the SIPA, all brokers or dealers registered under Section 15(b) of the Act are required to be members of SIPC unless subject to a specific exemption. 35/ "Specialized" brokers and dealers registered under Section 15C of the Act, whose securities business is limited to U.S. government and other exempt securities (except municipal securities), 36/ are not permitted to become members of SIPC. Accordingly, where a diversified securities firm registered pursuant to Section 15(b) of the Act 37/ has an affiliated specialized government securities broker-dealer registered pursuant to Section 15C of the Act, the Section 15(b) firm is a member of SIPC, whereas the Section 15C firm is not a member of SIPC. GAO indicates that some of these specialized dealers share the same office space and personnel with their diversified affiliates. GAO suggested that such a shared arrangement easily can keep customers from appreciating that transactions with different affiliates may carry different protection. In order to eliminate this confusion and to ensure additional investor protection, the GAO recommends that specialized government securities brokers and dealers be required to become members of SIPC.

In its response to GAO, SIPC raised a concern that all broker-dealers covered by SIPC be comparably regulated. 38/ Currently, while Treasury and SEC establish comparable federal agency financial responsibility rules, there is a gap in NASD regulation of such broker-dealers. Accordingly, if Congress determines to require SIPC membership for specialized government

---

34/ Report, at 64.

35/ 15 U.S.C. 78ccc(a)(2)(A).

36/ *See supra* note 2.

37/ *Id*.

38/ *See* letter from Theodore H. Focht, President and General Counsel, SIPC, to Richard L. Fogel, Assistant Comptroller General, GAO (June 27, 1990) ("SIPC Letter"), at 2-3.

securities brokers and dealers, it should also eliminate the limitations on the authority of the NASD to promulgate rules including testing and financial responsibility requirements, such as bonding and maintenance margin requirements, for transactions in exempted securities (other than municipal securities). 39/

We believe that such rules protect the SIPC fund as well as investors. Government securities broker-dealers who are SIPC members should be subject to a mosaic of protective requirements that are substantially similar to those currently applicable to SIPC member firms. While the Commission and Treasury capital and customer protection rules are the cornerstones of a strong financial responsibility program, NASD rules are designed to protect the integrity of the broker-dealer's financial resources. Fidelity bonding provides protection in the event of theft, embezzlement, or similar activity with respect to the property of the broker-dealer. Margin maintenance rules would tend to discourage imprudent credit extensions. Testing requirements are designed to preclude the entry into the business of persons who do not meet minimum standards of knowledge and competence and are relevant to the financial responsibility of the government securities broker-dealer insofar as they require the person responsible for a firm's financial responsibility to demonstrate familiarity with those requirements. 40/

Finally, in response to concerns raised by SIPC, 41/ GAO recommends that, if specialized government securities brokers and dealers are made members of SIPC, SIPC's assessment structure, which gives preferential treatment to revenue from certain instruments, including Treasury bills, should be modified so that all the specialized government securities broker-dealers pay

---

39/ See Joint Report, at 89-90.

40/ The GAO Report discussed qualification examinations, at 59-60. It reported that two NASD firms said that "exams should be required of chief financial officers of government speciali[zed] firms". GAO Report, at 59.

41/ In commenting on the GAO's draft report, SIPC stated that SIPA section 16(9)(K), 15 U.S.C. 78lll(9)(K), restricts the assessment on revenue earned from transactions in (i) certificates of deposit and (ii) Treasury bills, bankers' acceptances, and commercial paper that have a maturity of less than nine months to only a percentage of such revenue based on SIPC's loss experience with respect to such instruments over at least the preceding five years. SIPC believes that, if the specialized government securities dealers are to be given SIPC membership, the restriction on assessments must be eliminated or substantially modified. SIPC Letter at 2-3.

their fair share of the SIPC assessment burden. We agree that SIPC's concerns should be analyzed in order to assure that, if Congress mandates SIPC membership for these specialized firms, the specialized firms pay their fair share of the assessments that support the SIPC protection program.

II. Authority Issues

A. Proposed Expansion of Treasury's Rulemaking Authority to Require Broader Dissemination of Information

The Report recommends that Congress authorize Treasury to promulgate rules requiring all government securities interdealer brokers to make transaction information available to market participants on a real-time basis. Although the Commission does not disagree with GAO's discussion on the appropriateness of authorizing Treasury to promulgate rules in this area, we recommend that Congress also consider the alternative of designating the Commission as the appropriate rulemaker. As indicated below, arguments favoring the Commission focus on the Commission's substantial involvement in facilitating real-time transaction and quotation reporting, primarily in the markets for equity securities.

The Commission, under the authority provided it in Section 11A of the Act, 42/ has had a long history of working with the securities markets to develop more efficient mechanisms for assuring the widespread availability of transaction and quotation information. In the area of equities trading, the Commission in the past has worked with the exchange and OTC markets to develop, respectively: (1) a consolidated reporting system for real-time transaction 43/ and quotation 44/ information that ensures that trades and quotes in any exchange-traded security, wherever they occur in the United States, are available on a real-time basis; and (2) last-sale reporting of trades in the OTC market. 45/

42/ 15 U.S.C. 78k-1.

43/ See Rule 11Aa3-1 under the Act (17 C.F.R. § 240.11Aa3-1) ("Transaction Reporting Rule"); see also, Securities Exchange Act Release No. 10787 (May 10, 1974).

44/ See Rule 11Ac1-1 under the Act (17 C.F.R. § 240.11Ac1-1) ("Quote Rule"); see also, Securities Exchange Act Release No. 16518 (January 22, 1980), 45 FR 6521.

45/ See Transaction Reporting Rule; see also, Securities Exchange Act Release No. 17547 (February 17, 1981), 46 FR 13992.

Moreover, in carrying out the Congressional directive to facilitate the establishment of a national market system for securities, 46/ the Commission has gained valuable experience in addressing problems specific to the dissemination of real-time quotation and transaction information -- that is (among other issues), ensuring that securities information processors have access to that information on terms that are fair and not unreasonably discriminatory, 47/ and encouraging different trading markets to work together to develop national market system plans 48/ in order to avoid duplication of effort. 49/

There are, on the other hand, substantial arguments for designating Treasury as the appropriate rulemaker in this area. Treasury has both a critical interest in, and a position of unique proximity to, the government securities market. Through a network of twelve Federal Reserve district banks and their branches, Treasury sells Treasury bills, bonds and notes to public investors through a competitive auction process, for the purposes of financing the national debt. Accordingly, Treasury has a unique interest in ensuring the continued fairness, liquidity, and safety of the government securities markets. As the legislative history of the GSA states,

> As the manager of the public debt, the Treasury is responsible to Congress for managing that debt at the lowest

---

46/ See Section 11A(a)(2) of the Act, 15 U.S.C. 78k-1(a)(2).

47/ Section 11A(c)(1)(D) of the Act authorizes the Commission to prescribe rules to "assure that all exchange members, brokers, dealers, securities information processors, and . . . all other persons may obtain on terms which are not unreasonably discriminatory such information with respect to quotations for and transactions in such securities as is published or distributed by any self-regulatory organization or securities information processor." 15 U.S.C. 78k-1(c)(1)(D).

48/ Section 11A(a)(3)(B) of the Act empowers the Commission to "authorize or require self-regulatory organizations to act jointly . . . in planning, developing, operating, or regulating a national market system (or a subsystem thereof) . . . ." 15 U.S.C. 78k-1(a)(3)(B). Rule 11Aa3-2(b)(3) under the Act specifically authorizes SROs to act jointly in filing and implementing national market system plans and amendments thereto. 17 C.F.R. § 240.11Aa3-2(b)(3).

49/ The Commission recognizes the differences between debt and equity trading and, therefore, would not expect that reporting rules developed for the equity markets would be directly applicable to the debt markets.

possible cost. Therefore, the Secretary has the need for and responsibility to maintain a liquid and efficient market that has the continuing confidence of investors. 50/

Irrespective of whether Congress designates the Commission or Treasury as the appropriate rulemaker, the designated agency should be expected to work closely with, and give careful consideration to, the views of the other agency, if federal rulemaking ultimately proves necessary to achieve broader dissemination of pricing information in the government market.

B. Proposed Expansion of the Rulemaking Authority of the NASD and Treasury to Encompass the Regulation of Sales Practices

GAO's support for expanded NASD authority to promulgate and enforce compliance by government securities brokers and dealers with SEC-approved fair practice rules, especially in the areas of markups, suitability, and churning, 51/ derives from its view that the NASD as an SRO should have the authority to promulgate and enforce Commission-approved sales practice rules in its oversight of the government securities market. 52/ GAO's recommendation that Treasury establish federal sales practice standards, including specific benchmarks for determining excessive markups, 53/ is premised on a desire to deter potential abuses of individuals and smaller institutional investors.

The Commission believes that, if additional sales practice regulation is needed, the best approach would be for Congress to expand the NASD's authority to promulgate and enforce rules to promote just and equitable principles of trade in the sales practice area. As the Report points out, 54/ under Section 15A(f)(2) of the Act, the NASD generally is prohibited from adopting and implementing rules applicable to transactions by a registered broker or dealer 55/ in exempted securities. 56/

50/ S. Rep. No. 426, 99th Cong., 2d Sess. 12 (September 3, 1986).

51/ Report, at 57.

52/ *Id*. at 49.

53/ *Id*. at 89.

54/ *Id*. at 50, note 5..

55/ The term "registered broker or dealer," referenced in Section 15A of the Act, encompasses both broker-dealers registered or required to be registered under Section 15(b) (continued...)

Currently, as the Report 57/ acknowledges, the NASD has general responsibility under Sections 15A(b)(2) and (7) and 19(g)(1)(B) of the Act, 58/ to enforce compliance with the federal securities laws and rules and regulations thereunder. Toward that end, it may police excessive markups taken in government securities to the extent those markups violate Rule 10b-5 under the Act. Further, because churning has been held to violate

---

55/ (...continued) of the Act and those registered or required to be registered under Section 15C(a)(1) of the Act. See Section 3(a)(48) of the Act, 15 U.S.C. 78c(a)(48).

56/ The term "exempted securities" encompasses government securities except for purposes of Section 17A of the Act, which concerns the national clearance and settlement system. See Section 3(a)(12) of the Act, 15 U.S.C. 78c(a)(12)(A). This prohibition does not apply, however, to the NASD's adoption and implementation of rules that: (1) "enforce compliance by registered brokers and dealers with applicable provisions of this title and the rules and regulations thereunder"; or (2) apply to certain matters, such as the reasonable inspection and examination of the books and records of members, and the prevention of fraudulent, misleading, deceptive, and false advertising, set forth in Section 15A(f)(2) of the Act. See Section 15A(f)(2) of the Act, 15 U.S.C. 78o-3(f)(2). Accordingly, the NASD has promulgated rules, denominated "Government Securities Rules" ("GSRs"), designed to further its enforcement of compliance with the Act and rules and regulations thereunder and to regulate the discrete areas set forth in Section 15A(f)(2) of the Act. For example, Section 6 of the GSRs empowers the NASD to compel a member to reduce its business, or to prohibit the member from expanding its business, if certain capital thresholds are not met; Section 7 of the GSRs requires that a member obtain the prior written approval of the NASD in order to change its exemptive status under Commission Rule 15c3-3 from one particular category to another or to change from an exempt to a non-exempt status. The GSRs also contain rules: (1) requiring members to maintain books and records (Section 4); (2) requiring members to obtain advance approval of advertisements (Section 8); (3) requiring members to supervise their associates (Section 5); and (4) specifying sanctions for violation of the GSRs (Section 12). NASD Manual, ¶¶ 2421-2434, at 2261-2274.

57/ See Report, at 46.

58/ 15 U.S.C. 78o-3(b)(2) and (7); 15 U.S.C. 78s(g)(1)(B).

Rule 10b-5, 59/ the NASD also has authority to police churning violations consistent with its responsibility to enforce compliance with Rule 10b-5. Finally, because effecting unsuitable transactions in discretionary accounts, and recklessly stating that a security is sold "at the market" violate Section 15(c)(1) and, respectively, Rules 15c1-7 and 15c1-8 under the Act, 60/ the NASD may pursue suitability and false representation violations in the context of its overall responsibility to enforce compliance with the Act.

Nevertheless, GAO has suggested that expansion of the NASD's authority (subject to Commission oversight) would enhance investor protection by eliminating investor confusion about the scope of applicable regulatory protection. "Diversified" securities firms -- NASD members engaged in effecting transactions both in exempted and non-exempted securities -- are subject to more expansive NASD regulation with respect to their non-exempt business than with respect to their exempt business. GAO has suggested that the presence of an "NASD" seal or logo on the door or letterhead of such a firm may lead investors to believe they are receiving a degree of protection with respect to transactions in exempted securities commensurate with the protection in place with respect to transactions in non-exempted securities.

If Congress determines that additional sales practice regulation is needed, expansion of the NASD's authority in the sales practice area appears consistent with the overriding purpose of self-regulation. The legislative history preceding the Securities Acts Amendments of 1975, 61/ in reaffirming the system of self-regulation, cited, as an advantage of self-regulation, "the expertise and intimate familiarity with complex securities operations which members of the industry can bring to bear on regulatory problems, and the informality and flexibility of self-regulatory procedures." 62/ Conferring regulatory

---

59/ See, e.g., Costello v. Oppenheimer & Co., 711 F.2d 1361, 1368 (7th Cir. 1983); Thompson v. Smith Barney, Harris, Upham & Co., 709 F.2d 1413 (11th Cir. 1983); In re Catanella & E.F. Hutton and Co., 583 F. Supp. 1388, 1405, 1410-1411 (E.D. Pa. 1984).

60/ 15 U.S.C. 78o(c)(1); 17 C.F.R. §§ 240.15c1-7 and 15c1-8.

61/ Pub. L. No. 94-29, 89 Stat. 97 (June 4, 1975).

62/ Securities Industry Study Report of the Subcommittee on Securities, Senate Committee on Banking, Housing & Urban Affairs, S. Doc. No. 93-13, 93rd Cong., 1st Sess. 149 (1973).

authority in the sales practice area to a self-regulatory organization would be consistent with Congress' prior deference to the expertise and flexibility of market participants.

The Commission also agrees with GAO that mere expansion of the NASD's rulemaking authority, standing alone, will not fill the gap in regulatory sales practice coverage because the NASD's regulatory jurisdiction does not extend to banks acting as government securities brokers or dealers. 63/ Rather, if Congress wishes to provide comprehensive regulatory coverage, it should consider mandating rulemaking by a federal agency such as the Commission, with established authority over banks. Giving a federal agency authority to prescribe means reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices in connection with the purchase or sale of a government security or related advertising, which is analogous to that given the Commission under Section 15(c)(2) of the Act, 64/ would assure that financial institutions are held to similar standards where necessary, and that those standards are equally applicable to brokers and dealers. Expanded authority for both the NASD and a federal agency also would permit functional regulation of participants in the government securities markets vis-a-vis one another and also vis-a-vis participants in markets for other types of securities.

Sales practice rules ultimately promulgated by the federal agency would differ in scope from those adopted by the NASD. The former rules would apply to the government securities activities of all participants, whether securities firms or financial institutions, in the secondary market for government securities. The latter would only apply to the government securities activities of NASD-member securities firms. The Commission anticipates, however, that the two sets of rules would operate in harmony with one another. There would be no conflict between the two sets of rules, and the NASD rules would be required to be consistent with the rules promulgated by the federal agency. 65/ The NASD would have the authority, however, to establish stricter standards as it may do for corporate securities. With respect to government securities brokers and dealers not subject to the NASD's rules (see discussion, supra), the rules promulgated by the federal agency would apply.

63/ Under Section 15A(g)(1) of the Act, 15 U.S.C. 78o-3(g)(1), the NASD must deny membership to any person who is not a registered broker or dealer; banks do not meet the definition of registered broker or dealer set forth in Section 3(a)(48) of the Act, 15 U.S.C. 78c(a)(48).

64/ 15 U.S.C. 78o(c)(2).

65/ See Section 19(b)(2) of the Act, 15 U.S.C. 78s(b)(2).

There are two alternative methods of empowering a federal agency to adopt sales practice rules. The first alternative is to expand Treasury's rulemaking authority beyond the areas to which it is currently limited. This would have the advantage of keeping all rulemaking authority applicable to specialized government securities brokers and government securities dealers, including financial institutions, in the hands of the Treasury.

An alternative, and in some ways preferable, option would be for Congress to expand the Commission's authority under Section 15(c)(2) of the Act 66/ to prescribe means reasonably designed to prevent fraudulent, deceptive, and manipulative acts and practices to apply to transactions in exempted securities and extend such authority to government securities brokers and dealers that are financial institutions. Amending Section 15(c)(2) would follow the approach taken in that section to municipal securities, which gives the Commission authority over both bank and non-bank dealers. It would have the advantage of keeping all securities antifraud rulemaking authority with the Commission. Under either formulation, close cooperation would be required.

An important criteria in selecting the most appropriate regulatory agency is the desirability of "functional regulation" of securities. As a general matter, the Commission believes that functional regulation can provide enormous benefits by promoting efficiency, effectiveness and consistency among different types of organizations providing a similar service. This principle was a key element of the recommendations of the Bush Task Group on Regulation of Financial Services. Its importance has been more recently noted in the Treasury report, Modernizing the Financial System: Recommendations for Safer, More Competitive Banks. Based on functional regulation, it is the common category of product and activity being performed -- here the sale of securities -- that ordinarily should be regulated by a single agency under a set of common rules. Many investors routinely consider investments in both corporate and governmental debt securities, as well as corporate equities at the same time. Unless the function of selling those products has a single regulatory agency and a single set of sales practice requirements, the protection to any such investor could differ based on the type of security being recommended. Thus, Congress should consider whether a broker or dealer (including a financial institution), when it sells or attempts to sell a security, regardless of issuer, should be subject to a system of securities regulation administered by a single agency. Obviously, any such system can and should make appropriate distinctions between securities based on their fundamental characteristics, and the

---

66/ 15 U.S.C. 78o(c)(2).

nature of the trading market, but the issue is whether such distinctions should be created by a regulatory agency with a common perspective of investor protection.

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

April 1, 1991

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Mr. Chairman:

Thank you for your letter requesting our comments on issues presented in reports concerning the Government Securities Act of 1986 (GSA). In your letter you requested that we address three issues from the October 1990 Study of the Effectiveness of the Implementation of the Government Securities Act of 1986 (Joint Report) in which the Department of Treasury, the Securities and Exchange Commission, and the Federal Reserve Board were unable to concur on recommended courses of action. These three issues are sales practice rules, expanded access to pricing information, and increased availability of Securities Investor Protection Corporation (SIPC) insurance coverage. You also asked us to comment on the specific proposals in the September 1990 GAO Report, U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed (GAO Report). In addition, you asked us to discuss our government securities examination cycle and the record of national banks' compliance with the GSA.

GSA Rulemaking Authority

We support the extension of the Secretary of the Treasury's (Treasury) rulemaking authority under GSA as recommended in both the Joint and GAO Reports. We also agree that Treasury should be given the authority to promulgate sales practice rules and rules expanding access to price information.

Sales Practice Rules

We concur with the GAO Report that Treasury should be given the authority to promulgate sales practice rules, and that they should specifically address the areas of securities mark-ups and customer suitability. We believe that the commonly accepted fair practice provisions in the Municipal Securities Rulemaking Board (MSRB) rules and other regulatory frameworks could be used as a basis for GSA amendments, and that the new GSA rules should be specific enough to ensure proper control and internal monitoring of these areas.

It is important that the proposed rules focus on mortgage-backed securities (MBS) issued by federal agencies and government sponsored corporations. Most other government securities (Securities) have relatively homogeneous terms and conditions, which permit a clear understanding of the Securities and make them easy to price. However, MBS products are unique in their prepayment characteristics, making them far more difficult for investors to price and manage the MBSs' cash flow.

Pricing Information

We also agree with the GAO Report that non-primary dealers and any investors willing to purchase the information should have access to transaction information about Securities from interdealer broker screens, and other pertinent sources. The screens will provide non-primary dealers and investors with information on Securities wholesale prices and volume. This information will give them a more complete understanding of the market, and permit them to more accurately determine the prices they are prepared to pay for Securities.

SIPC Insurance Coverage for Specialist Brokers and Dealers

We have no opinion as to whether specialist broker/dealers should be covered by SIPC insurance as recommended in the GAO Report. We do not regulate specialist broker/dealers and believe that any actions regarding SIPC coverage for these institutions should be addressed by those more involved with the issue.

SIPC Insurance Coverage for National Bank Dealers

We concur with the GAO Report that there is already a considerable degree of comparability in investor protection between SIPC insurance and the various types of insurance coverage purchased by dealer and non-dealer banks. FDIC insurance covers customer cash positions deemed to be deposits up to $100,000, and blanket bond insurance protects customers' securities held in safekeeping from employee misappropriation. In addition, if banks are required to purchase SIPC insurance along with their current blanket bond and FDIC insurance, they may be paying multiple insurance premiums for overlapping coverage. We believe this issue must be explored more thoroughly before any changes are made requiring banks to purchase SIPC insurance.

GSA Examination Frequency and Results

We believe that OCC examination policies provide sufficient oversight of national bank compliance with GSA rules. MSRB rules require compliance examinations for municipal securities dealers to be conducted within a 24-month period. Although GSA does not specify examination frequency in its regulations, OCC often conducts the Securities and municipal securities compliance examinations at the same time. GSA's requirements are somewhat similar to those of MSRB, and government securities activities are nearly always conducted in the same department. The Dealer often uses the same recordkeeping and operational controls for both areas.

In its discussion of dealer bank examination frequency, the GAO Report suggested that examining Dealers less frequently than once a year is less effective in maintaining compliance with GSA than an examination cycle of one year or less. Greater examination frequency does not necessarily ensure a higher level of industry compliance. One example of this is the municipal securities industry, which maintains a high level of MSRB rule compliance using a 24-month examination cycle. Although examination frequency is a factor in promoting compliance, the thoroughness of the examination must also be considered in assessing examination effectiveness. The Joint Report, although expressing concern with the number and frequency of examinations conducted, noted that OCC examination procedures are thorough, and that we promptly inform our examination staff of GSA changes to be used in procedure updates.

Our examination policy for non-dealer banks is to schedule examinations based on a bank's asset size, random sampling, and identified need. All banks with assets of $1 billion or more are examined at least every other year; in 1991, OCC has scheduled compliance examinations for selected activities at 85% of those banks. Banks with special issues are examined by a schedule established on a case-by-case basis. All other banks are examined through a random sampling process. We believe that the possibility of being randomly selected for a compliance examination creates an incentive for banks to comply with GSA and other laws. Other government agencies, such as the Internal Revenue Service, have successfully used audits of randomly selected individuals and businesses to ensure compliance with laws and regulations. Based on our experience to date, we believe that OCC's examination schedule is adequate to oversee national banks' compliance with GSA laws.

In your letter, you also asked us to respond to the GAO's finding that examinations revealed a high incidence of noncompliance with the GSA regulations. In performing their first examination of banks after the new regulation was adopted, our examiners did discover that a high percentage of those banks had committed one or more violations, but that the violations were, for the most part, nonsubstantive ones. The GAO report indicated that the SEC and NASD also found a high level of technical violations during their first round of examinations. It is our experience that compliance with new rules substantially improves after the first round of examinations. The types of nonsubstantive violations we noted can be easily corrected by the dealers and banks, and discussions with examiners revealed that most dealers and banks corrected the violations before the examiners conducted their final Board meetings.

If you have any questions or wish to discuss this further please do not hesitate to contact us.

Sincerely yours,

Robert L. Clarke
Comptroller of the Currency

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

January 23, 1991

Dear Mr. Chairman:

Thank you for your joint letter with Senator Heinz requesting comment by the Federal Deposit Insurance Corporation on certain legislative recommendations of the General Accounting Office.

We have enclosed the views of the FDIC which we hope will be helpful. If you have any further questions, please let us know.

With best wishes.

Sincerely,

L. William Seidman
Chairman

Honorable Christopher J. Dodd
Chairman
Securities Subcommittee
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Enclosure

Response to Inquiry from Senators Dodd and Heinz

1. Study of the Effectiveness of the Implementation of the Government Securities Act of 1986.

The Federal Deposit Insurance Corporation supports the recommendation that Congress act to extend the Treasury Department's rulemaking and exemptive authority. We agree that there has been effective consultation and coordination between the Department and other federal agencies in implementing the regulatory process. The Department is in a favorable position to coordinate the views of the various entities and to provide a balanced regulatory treatment of the various types of government securities brokers and dealers.

Several technical changes to the Securities and Exchange Act of 1934 are recommended in the Study. We agree with these recommendations.

2. U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed.

In preparing the study, Treasury, Federal Reserve Board and SEC staff were unable to reach a consensus on the need for additional regulation in three areas:

(a) Sales practice rules for the government securities market;
(b) Increased public access to government securities pricing information; and,
(c) Expansion of Securities Investor Protection Corporation insurance to customer accounts at registered government securities brokers or dealers.

In its report, the General Accounting Office made recommendations for additional regulatory authority in these three areas. Each of these issues is discussed below.

Based upon our examinations of government securities brokers and dealers, we have not found any abuses of sales practices. In banks with both a municipal securities dealer and a government securities broker/dealer, our examiners usually conduct concurrent examinations of both dealer operations and generally apply the Municipal Securities Rulemaking Board sales practices rules as a guide for government securities.

Government securities dealers and brokers are subject to the anti-fraud provisions of Section 10(b) of the Exchange Act. Our examiners have not reported any fraudulent, manipulative or deceptive acts or practices under this Section. In addition, the complaint data base was searched for the last year and we found no complaints related to the purchase or sale of government securities or complaints, of any nature, against any government securities broker/dealer under our jurisdiction.

In its report, the GAO reasoned that if sales practice rules make sense for other markets then they also make sense for the government market. However, the GAO states that no attempt was made to assess the prevalence of sales practice abuses in the government securities market nor did it attempt to evaluate the effectiveness of sales practices rules in preventing abuses. Without any evidence of abuses of sales practices, we think that the additional costs and burden of new regulations on the government securities industry continue to outweigh any perceived benefits.

The GAO recommended that Congress amend the Exchange Act to require that government securities transactions information from screen brokers, and any trading systems that serve a similar function, be made available on a real time basis to those willing to pay appropriate fees. In general, we support the concept of greater access to price information by all brokers and the public. However, we are unable to offer specific recommendations on achieving the goal of greater access to price information.

The GAO also recommended that Congress amend the Exchange Act to require that all non-bank government securities specialist dealers provide SIPC coverage if their business is similar to that for which SIPC coverage normally applies in SEC-registered securities markets. While the GAO raised the issue of the possible need of SIPC coverage for bank government securities dealers, GAO's specific recommendation only relates to government securities specialist dealers which are not banks. Since these dealers are outside our jurisdiction, we offer no recommendations on this matter.

We support the recommendations that Congress act to extend Treasury's rulemaking and exemptive authority and that the technical changes to the Securities and Exchange Act of 1934 be adopted. We do not support GAO's recommendation for new legislation that would authorize sales practice rules. At this time, we offer no other amendments to the Government Securities Act of 1986.

3. Other Information Requested.

The GAO report raised questions about the frequency of examinations and Senators Dodd and Heinz requested that we describe our examination cycle and comment upon this portion of the GAO report. Our policy is to examine government securities brokers/dealers at least once in each 24-month period unless there are significant weaknesses or deficiencies resulting in a less than satisfactory rating. In such cases, the maximum interval between examinations is twelve months. Additional examinations or visitations are encouraged when deemed necessary by the Regional Director.

In its review of examination results, the GAO has stated that there is a high incidence of noncompliance with the Act by government securities dealers. It is true that we have found some violations by most of the dealers examined. We believe that two factors should be considered in judging these examination results. The first factor is that this is a new law and these are the first examinations after the law was enacted. The second factor relates to the nature of the violations. Many of the violations involve failure to file forms, recordkeeping, and record retention. While all violations are considered serious, these types of violations are of a more technical nature and do not seriously impair investor protection. At this time, we do not believe that any additional regulatory tools are necessary.

1989

Office of Thrift Supervision
Department of the Treasury

Timothy Ryan
Director

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6280

February 20, 1991

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Dodd:

I write in response to your letter dated December 10, 1990, in which you ask for the views of the Office of Thrift Supervision regarding the recommendations contained in two studies about the implementation of the Government Securities Act of 1986 ("Act"), Study of the Effectiveness of the Implementation of the Government Securities Act of 1986 prepared by the Department of Treasury, Securities and Exchange Commission, and Board of Governors of the Federal Reserve ("Agency Report") and U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed prepared by the General Accounting Office ("GAO Report"), and the OTS experience with the examination of government securities dealers.

According to agency records, the OTS does not currently regulate any savings associations that are registered as government securities dealers. The GAO Report notes that as of July 1989 there was only one savings association registered as a government securities dealer and that it was not active. Since then, that thrift has gone into receivership.

Accordingly, the OTS has extremely limited experience on which to base a response to your request. However, we understand that the Department of Treasury has thoroughly reviewed these matters and is making recommendations to you. We fully support the recommendations of the Department of Treasury.

The OTS continues to conduct regular and special examinations of its savings associations and these examinations are designed to discover any serious regulatory deficiencies. To date, these examinations have not revealed the need for any savings association to register as a government securities broker or dealer.

I hope that this letter is responsive to your inquiry. If this agency can provide additional information to your Subcommittee, please do not hesitate to contact us.

Sincerely,

Timothy Ryan
Director

SIPC

SECURITIES INVESTOR PROTECTION CORPORATION
805 FIFTEENTH STREET, N.W. SUITE 800
WASHINGTON, D.C. 20005-2207
(202) 371-8300

OFFICE OF THE GENERAL COUNSEL

February 7, 1991

The Honorable Christopher J. Dodd
The Honorable John Heinz
Securities Subcommittee
Committee on Banking
 Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Senators Dodd and Heinz:

This is in reply to your letter of December 10, 1990, in which you asked for SIPC's comments on (i) the recommendations for legislation contained in the Study of the Effectiveness of the Implementation of the Government Securities Act of 1986 ("Joint Study"); (ii) the appropriateness of additional amendments to the Government Securities Act of 1986 ("GSA"); (iii) the General Accounting Office's ("GAO") September 1990 report entitled U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed ("GAO Report"); and (iv) questions in the GAO's report about the frequency of examinations of certain bank and thrift government securities dealers.

The Joint Study, submitted to Congress in October 1990 by the Department of the Treasury ("Treasury"), the Board of Governors of the Federal Reserve System ("Board"), and the Securities and Exchange Commission ("SEC"), makes two recommendations for legislation, namely, the continuation of Treasury's rulemaking authority for all government securities dealers and the amendment of two sections of the Securities Exchange Act of 1934 ("Exchange Act"). SIPC has no comment on either of these two recommendations.

The Joint Study (at 77-90) addresses, without recommendations for legislation, three specific areas for which the GAO in its report recommended that Congress amend the Exchange Act to provide for additional regulatory authority. Those areas are: (1) sales practice rules for the government securities market; (2) increased public access to government securities pricing information; and (3) expansion of SIPC protection [insurance] to customer accounts at registered government securities brokers or dealers. The Joint Study noted, however, (at 77) that the study participants "have not reached consensus on the need for, or scope of, additional regulatory authority to address these issues."

The GAO Report makes a number of recommendations, including two of particular interest to SIPC (at 64), namely, the extension of SIPC coverage to customers of all non-bank government securities specialist firms "if their business with customers is similar to that for which SIPC coverage normally applies in SEC-registered securities markets" and the modification of SIPC's assessment structure "so that specialist firms covered by SIPC pay their fair share of the assessment burden."

SIPC would like to make a few introductory comments about the Securities Investor Protection Act of 1970 ("SIPA"), the membership of broker-dealers in SIPC, the registration of municipal securities dealers with the SEC under the Securities Acts Amendments of 1975, and the registration of government securities broker-dealers with the SEC under the GSA.

When Congress enacted SIPA in 1970 and established SIPC to protect customers of SIPC member broker-dealers for the cash and securities which those members are holding for customers, Congress mandated clear membership requirements for SIPC. Pursuant to SIPA section 3(a)(2)(A), 15 U.S.C. §78ccc(a)(2)(A), all broker-dealers, with minor exceptions, registered with the SEC under section 15(b) of the Exchange Act, 15 U.S.C. §78o(b), are automatically members of SIPC.

In 1975 when Congress mandated that municipal securities dealers register with the SEC and extended SIPC protection to these firms' customers, these firms registered under section 15(b) of the Exchange Act and thus became SIPC members. Certain municipal securities dealers, not requiring membership in the SIPC protection program, registered under section 15B of the Exchange Act, 15 U.S.C. §78o-4, and did not become SIPC members.

As noted above, the GSA required the registration of government securities dealers with the SEC under either section 15(b) or section 15C of the Exchange Act. Many government securities dealers registered under section 15(b) and became SIPC members. Only 63 did not. They registered under section 15C.

The GAO Report is silent as to whether the 63 government securities dealers, which the report recommends become SIPC members, would register with the SEC under section 15(b) of the Exchange Act as does every current SIPC member. One may surmise, however, that the report contemplates both the SIPC membership of these 63 government securities dealers and their continued registration under section 15C of the Exchange Act, because of the report's recommendation that the Treasury continue to write the rules for these 63 entities.

This would be the first time that Congress would consider SIPC membership for entities not registered under section 15(b) of the Exchange Act and not subject to the full rulemaking authority of the SEC. SIPC believes that such a major departure from prior practice must be thoroughly thought through, explored, and discussed.

Of special concern to SIPC is the precedent of having SIPC members subject to financial responsibility rules written by different agencies. Up to now, the financial responsibility rules governing the approximately 10,000 SIPC members have been uniform and have been written by the SEC. SIPC, therefore, supports the efforts of the current joint study group, composed of Treasury, the Federal Reserve System, and the SEC, to reach a uniform capital rule for both registered government securities brokers and dealers and registered brokers and dealers. (Joint Study at 72.) SIPC also supports legislation which would authorize the adoption of rules of fair practice applicable to all non-bank government securities brokers and dealers. See Joint Study at 90n.75.

Also of concern to SIPC is that a large portion of the business of non-bank government securities brokers and dealers involves repurchase and reverse repurchase agreements ("repo" and "reverse repo"). SIPC does not consider participants in repo and reverse repo transactions to be under the SIPC protection umbrella, although one federal district court has held to the contrary. In fact, the SIPC Repo Task Force, whose membership included representatives of the Joint Study participants,[1] "unanimously concluded that, as a matter of policy, participants in repo [and reverse repo] transactions should not be afforded the protections made available to 'customers' under SIPA." Report to the Board of Directors of the Securities Investor Protection Corporation by the SIPC Repo Task Force (September, 1989) at 3. ("SIPC Repo Task Force Report")(Copy enclosed.) Thus, any extension of SIPC protection to customers of non-bank government securities brokers and dealers should be accompanied by legislation clarifying the status under SIPA of repo and reverse repo participants.

In fact, such extension of SIPC protection could also necessitate a review of SIPC's current practice of assessing repo related revenues on a net basis, rather than on the gross basis used for all other protected securities transactions. SIPC Repo Task Force Report at 26. It would not be equitable to provide such protection to repo participants and not at the same time change the basis for the assessment of repo revenues. As noted by the SIPC Repo Task Force (at 26), "any such change would likely have considerable impact on the repo markets and certainly on the SIPC members participating in the repo markets."

---

[1] These representatives were ex officio Task Force members and were speaking for themselves and not their agencies.

The Honorable Christopher J. Dodd
The Honorable John Heinz
February 7, 1991
Page 4

In response to your last request for comment, SIPC can only say that it is not involved in regulating or inspecting banks and thrifts or in protecting their depositors, and therefore has no comment on the questions in the GAO's report (at 38-41) about the frequency of examinations of certain bank and thrift government securities dealers.

Very truly yours,

Theodore H. Focht
President and General Counsel

THF:KHB/tgl
Encl.

National Association of
Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006
(202) 728-8000

February 1, 1991

Honorable Christopher J. Dodd
Chairman
Honorable John Heinz
Ranking Minority Member
Securities Subcommittee
Committee on Banking, Housing and
Urban Affairs
Washington, D.C. 20510-6075

Dear Senators Dodd and Heinz:

This letter responds to your December 10, 1990 request for the National Association of Securities Dealers (NASD) views on recommendations for legislation contained in the Study of the Effectiveness of the Implementation of the Government Securities Act of 1986 (Joint Study), submitted to Congress in October, 1990 by the Department of the Treasury (Treasury), the Board of Governors of the Federal Reserve System (FRB) and the Securities and Exchange Commission (SEC), as well as our views on whether additional amendments to the Act are appropriate. Your letter also requests our views on the findings and recommendations of the Government Accounting Office's September 1990 study titled U.S.Government Securities: More Transaction Information and Investor Protection Measures Are Needed (GAO Report), and any legislative language the NASD would suggest. Responses to your requests are presented in the order posed in your letter.

The Joint Study

The Joint Study contains three basic recommendations for legislation. The first would extend Treasury's rulemaking authority under the Government Securities Act of 1986 (GSA). The other two recommendations suggest certain definitional amendments to the Securities and Exchange Act of 1934.

The NASD supports the recommendations of these various government agencies to extend Treasury's rulemaking authority in the government securities market. Exercise of this authority by Treasury has improved investor safety while minimizing the impact of regulation on the efficient functioning of this extremely important and large market. Moreover, Treasury has consulted and coordinated with the SEC, the FRB, the NASD, and the various other enforcement and self-regulatory entities both during the rulemaking process and afterwards. The NASD believes the Treasury has properly discharged its rulemaking responsibilities since the GSA was passed, and it should continue in this important role.

The NASD also supports the Joint Study's recommended definitional changes to Securities and Exchange Act Sections 3(a)(34)(G) and 3(a)(46). The changes to Section 3(a)(34)(G) would align enforcement responsibilities with existing supervisory practices more accurately by changing the designation of the "appropriate regulatory agency" for certain financial institutions and insured state branches of foreign banks, and would define the term "savings institution" which is not presently defined in the act. The change to Section 3(a)(46) would correct an inadvertent result of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

GAO Report

The Joint Study presents issues involving three important sectors of the government securities market without making recommendations: sales practice rules for the government securities market; expanded access to government securities pricing information; and expansion of SIPC insurance coverage. The GAO Report recommended legislation in each of these areas. The NASD supports these recommendations.

Sales Practice Rules The GAO recommendation most strongly supported by the NASD is summarized in Chapter 3 of its report in a section entitled "NASD should have authority to enforce sales practice rules in the government securities market," in which the GAO recommended:

> ...that Congress amend Section 15 of the Exchange Act (and such other statutes as may be necessary) to authorize a federal agency to adopt general rules of fair practice applicable to all government securities brokers and dealers. Self-regulatory organizations and bank regulators should also be authorized to develop and enforce specific requirements within the context of general rules. The rules, at a minimum, should cover dealer pricing practices (mark-ups) and investors suitability requirements.

Under the GSA, the NASD has no authority to apply its rules regulating sales practices to the government securities firms for which it has regulatory responsibility. Inconsistently, however, the GSA does not prohibit registered securities exchanges, such as the New York Stock Exchange (NYSE), from applying its sales practice rules to government securities dealers. Bank examiners apparently apply the Municipal Securities Rulemaking Board's sales practice guidelines to banks government securities activities; however, their authority to do so is not clear from the language of the GSA.

The NASD examines approximately 63 dealers that specialize in government securities and more than 1,300 diversified broker-dealers that engage in government securities transactions. Even though the NYSE, which has the examination responsibility for 168 broker-dealers, and the bank regulators, which have the examination responsibility for 280 bank dealers, apparently have the authority to surveil for abuses or unethical sales practices, the NASD cannot do so for its members. Since these dealers sell substantially the same product to the same types of investors regardless of who regulates them, the omission of sales practice enforcement authority from the NASD under the GSA has created a significant gap in regulation of this critically important market. This should be corrected if investors are to be accorded even and fair protection.

While the focus of abuses when the GSA was written in 1986 was repurchase agreements, there have since been widely publicized cases in the government securities markets that have been pointed to as examples of sales practice abuse. As these markets have grown in size and complexity, the potential for abuse has been increasing, especially among less sophisticated individual and small institutional investors.

This growth in the potential for abuse is especially true as individual investors in recent years increasingly seek what they believe is greater safety in any investment related to a government security. These investors are growing in numbers and are encouraged by the creation of Treasury STRIPS, collateralized mortgage obligations, and other innovative products that make it easier for them to invest in government securities. While marketed as government securities, these investments can be very speculative and investors may be unfamiliar with their complexity and risks. Investors would, in our judgement, benefit from sales practice regulations, especially those governing excessive mark-ups and unsuitable recommendations, which are applied to other securities.

Currently, the NASD can take disciplinary action against one of its members in connection with government securities sales practice activity only where the violative conduct rises to the level of fraud, thus requiring proof of intent. This approach allows higher markups and lower standards than the accepted norm for other securities, because of the difficulty in proving fraudulent intent. The NASD's enforcement mechanism has considerably more flexibility and precision because it is based on ethical business standards developed by experts in the area under consideration, and makes use of businessman's judgements by the alleged violator's peers. Since NASD's markup rules (which could be adjusted to specifically address markups in government securities) are standards of ethical conduct and do not require proof of fraudulent intent, they can more easily be enforced. Application of the NASD's suitability rules would similarly help protect customers from unsuitable investments in products that present risks often unknown to the unsophisticated or uninformed.

The GAO Report states:

> sales practice rules that supplement the basic anti-fraud provisions of the securities laws have become a fixture in securities markets in the United States. If these rules make sense for other securities markets, then they also make sense for the government market as well, because there are similarities for abuse in both types of markets.

The NASD agrees with this conclusion.

Rules developed by self regulatory organizations would capitalize on the flexibility needed to keep regulation current with developments in the market, provide the inter-market comparability needed, and underline the importance of government securities regulation. The NASD believes that sales practice rules are more appropriately developed at the SRO level where the standards of business practice and ethics play a much larger role and the expertise of those in the business is utilized in developing the appropriate standards. Federal oversight and approval should, of course, be continued and is supported by the NASD.

Qualifying Examinations for Government Securities Brokers and Dealers - The NASD supports the GAO suggestion to require qualifying examinations for government securities brokers and dealers. While such an examination is no guarantee of competency or integrity, it would help to assure that government securities principals and sales personnel understand, among other requirements, customer suitability requirements for the riskier government zero coupon and mortgage backed securities now being bought by less sophisticated retail customers. Qualification examinations would be a valuable adjunct to sales practice rules as a protection to investors. The government securities market is the only area of the securities industry not currently subject to such requirements.

Availability of Government Securities Transaction Information - The NASD supports the GAO recommendation to expand access to government securities transaction information on a real time basis to anyone willing to pay the appropriate fees. Our experience with operating and developing the NASDAQ system has been that increased disclosure not only adds to the efficiency of the market, but also substantially increases investor protection by providing easy and open access to pricing information. We also note that at your recent hearing on the health of the securities markets, SEC Chairman Richard Breeden stated that he supported this expanded access to brokers' information.

Extension of SIPC Coverage to Government Securities Specialists Dealers - This GAO recommendation would require SIPC coverage of all non-bank dealers specializing in government securities. The NASD supports this recommendation. There are 1,559 registered government securities firms. Only 63 of them are government securities specialists firms; however because of the specific language of the statute only they are not covered by SIPC. Customers of general securities firms purchasing government securities are afforded SIPC protection, and so should those of the specialists firms. Expanding SIPC coverage to these firms would help to maintain the integrity of the primary government securities market as well as the continuing development of, and confidence in, a strong secondary market.

The NASD believes that this recommendation is also justified by the rationale that recurs frequently in the GAO Report -- that it would eliminate distinctions between the government and SEC-registered securities markets that are no longer justified, especially as less sophisticated investors enter the government securities market. In many cases such investors are unaware of the distinction and would certainly fail to understand why they would receive less protection in a closely comparable situation.

NASD examination cycle and record of compliance from examinations. - The NASD examination cycle for government securities firms requires that they be examined prior to membership, and then again within six months of becoming a member. After the first year, the clearing firms are examined annually, and the introducing firms (i.e. firms that do not carry customer accounts on their own but introduce them to clearing firms) are examined every other year. This is a minimum schedule. If the NASD has reason to believe the firm is experiencing problems, examinations are more frequent. In addition to this examination program, the NASD receives monthly financial reports and annual certified independent audits on these firms.

The NASD believes that it has carefully discharged its examination responsibilities under the GSA. When this legislation was originally enacted, the NASD conducted in-depth examinations of all government securities applicants prior to admission to membership. We believed this approach prudent because we anticipated a large number of record keeping problems that should be solved before the firms became members. While some firms were admitted with record keeping problems, the Treasury granted those firms no action relief for a limited period of time to enable them to bring their records into compliance. These examinations at the outset were educational to the new government broker dealers especially those which had not previously been subject to regulation of any kind.

Attachment A provides the results of our 1989 compliance examinations (the last full year for which data are available) for dealers registered with the NASD under Section 15C of the Securities Exchange Act to do only a government securities business.

Legislative language needed - To implement the NASD's request for rulemaking authority, we have attached our suggested changes to the Securities Exchange Act of 1934. They would vest the NASD with the same authority that the exchanges exercise over government securities dealers for which they have the examination responsibility by removing current limitations on the NASD. The language changes delete current Securities Exchange Act Sections 15A (f)(1) and (2) and Section 15A(g)(3)(D) and renumber Section 15A (f)(3) as Section 15A(f).

If you have any questions on the contents of this letter, or need additional information, please do not hesitate to contact me at 202/728-8100, or Frank Formica at 202/728-8289.

Sincerely,

Joseph Hardiman
President

Attachment

RULE VIOLATIONS FOUND IN THE 67 EXAMINATIONS OF GOVERNMENT SECURITIES BROKER/DEALERS COMPLETED IN 1989

Treasury Rules	Area	Violations
402.	Net capital	4
403.	Customer protection	2
404.	Record keeping	4
405.	Financial reporting	2
S.E.C. Rules	**Area**	**Violations**
10b-10	Confirmations	12
15(b)3-1	Form BD not current	2
15c3-1	Net capital	1
15c3-2	Notice of customers free credit balances	1
15c3-3	Customer protection	24
17a-3	Making records	48
17a-4	Keeping records	8
17a-5	Financial reporting	27
17a-8	System to review cash transactions	11
17a-11	Early warning reports	1
17a-13	Quarterly securities count	12
17f-1	Fingerprints	7
17f-2	Registration with securities information system	5
NASD Government Securities Rules		13

NASD Recommended Changes to Securities Exchange Act Section 15A

Deletions are ~~struck through~~

(f)~~(1) Except as provided in paragraph (2) of this subsection, nothing in this section shall be construed to apply with respect to any transaction by a registered broker or dealer in any exempted security.~~

~~(2) A registered securities association may adopt and implement rules applicable to members of such association (A) to enforce compliance by registered brokers and dealers with applicable provisions of this title and the rules and regulations thereunder, (B) to provide that its members and persons associated with its members shall be appropriately disciplined, in accordance with subsections (b)(7), (b)(8), and (h) of this section, for violations of applicable provisions of this title and the rules and regulations thereunder, (C) to provide for reasonable inspection and examination of the books and records of registered brokers and dealers, (D) to provide for the matters described in paragraphs (b)(3), (b)(4), and (b)(5) of this section, (E) to implement the provisions of subsection (g) of this section, and (F) to prohibit fraudulent, misleading, deceptive, and false advertising.~~

~~(3)~~ Nothing in subsection (b)(6) or (b)(11) of this section shall be construed to permit a registered securities association to make rules concerning any transaction by registered broker or dealer in a municipal security.

(g)(1) A registered securities association shall deny membership to any person who is not a registered broker or dealer.

...

~~(D) Nothing in subparagraph (A), (B), or (C) of this paragraph shall be construed permit a registered securities association to deny membership to or condition the membership of, or bar any person from becoming associated with or condition the association of any person with, a broker or dealer that engages exclusively in transactions in exempted securities.~~

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-1000

OFFICE OF THE ASSISTANT SECRETARY FOR
LEGISLATION AND CONGRESSIONAL RELATIONS

JAN 31 1991

Honorable Christopher J. Dodd
United States Senate
Washington, D.C. 20510-6075

Dear Senator Dodd:

Thank you for your December 10, 1990 letter addressed to Arthur J. Hill, President of the Government National Mortgage Association (GNMA), requesting GNMA's views on the specific issues detailed in your letter. The views below are based on the information contained in the Study of the Effectiveness of the Implementation of the Government Securities Act of 1986, as distributed by the Department of the Treasury, the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission, and the report entitled U.S. Government Securities; More Transaction Information and Investor Protection Measures Are Needed, produced by the General Accounting Office.

GNMA has been requested to express its views on the conclusions made by the joint study pertaining to technical changes put forth and the extension of the Treasury's rulemaking authority. GNMA concurs with the conclusions drawn and the technical legislative recommendations made based on review of the joint study. The continuation of the Treasury's oversight appears to be the logical progression at this time. GNMA is not privy to any information that would alter the basic views expressed and conclusions drawn in the joint study and, therefore, will not submit any additional amendments to the Act.

Regarding the request for comments on the recommendations contained in the GAO's report, GNMA is not in a position to comment on the Treasury's authority over sales practices of government securities brokers and dealers nor on the extension of Securities Investor Protection Corporation based on the limited GNMA exposure in these areas. GNMA feels any comment on these subjects should not be made on issues where sufficient analytical resources are not available and we have had no direct experience. As to the further dissemination of pertinent data, GNMA does feel in theory that relevant information available to the marketplace will enhance the overall efficiency in the secondary markets, in particular the secondary mortgage market.

The final request pertains to the frequency of examinations of government securities dealers. GNMA would support reasonable efforts to reduce noncompliance with the Act. Regarding the regulatory examination of dealers, GNMA would defer to the regulatory bodies currently responsible under the Act as to their level of satisfaction with the examination process.

We appreciate the opportunity to express our views on certain current and potential provisions of the Government Securities Act of 1986 and the related studies. We sincerely hope the responses are of value to the process and look forward to assisting the Subcommittee as necessary.

Very sincerely yours,

Timothy L. Coyle
Assistant Secretary

3900 Wisconsin Avenue, NW
Washington, DC 20016-2899
202 752 6016

Gary L. Perlin
Senior Vice President—
Finance and Treasurer

FannieMae

January 24, 1991

The Honorable Christopher J. Dodd
Securities Subcommittee
Committee on Banking, Housing, and
  Urban Affairs
United States Senate
Washington, DC   20510-6075

Dear Senator Dodd:

David Maxwell asked me, as Fannie Mae's Treasurer, to respond to your invitation for comments on proposed technical amendments to the Government Securities Act of 1986. I welcome this opportunity because efficient and responsible government securities markets are essential to Fannie Mae's ability to issue debt and mortgage-backed securities (MBS) in all economic circumstances and, in turn, to the corporation's fulfillment of its mission to provide ongoing support to the U.S. housing market.

As the largest securities issuer next to the U.S. Treasury, Fannie Mae shares with Treasury its interest in promoting fair, honest and liquid markets in government securities. We therefore support an extension of the Treasury's rulemaking authority over the government securities market. In so doing, we urge that the Subcommittee recognize in its deliberations the integral relationship among all government securities as defined by the Act and the resulting need to have them subject to the same rulemaking authorities. Specifically, in light of market practices, similarities among the securities' risk characteristics and Fannie Mae's congressional charter, it is appropriate that securities issued by Fannie Mae (including debt obligations and MBS) be treated like Treasury securities for purposes of enforcing the Act.

As an active participant in the fixed income markets, Fannie Mae would also welcome expanded, real time access to pricing information relative to government securities trading. We hope and expect that the securities industry will offer this access in an effective and cost-efficient way even before it is legislatively mandated to do so.

We have no particular view on the expansion of Securities Investor Protection Corporation insurance coverage, largely because the specialist government securities firms with whom we work tend to do business on a wholesale basis with investors for whom SIPC coverage would be trivial.

Fannie Mae's expertise is as a securities issuer and not as a market regulator. We have gone to great lengths to deal only with responsible market participants and to assure that we make appropriate disclosure regarding the terms of our securities. However, we do not feel qualified to comment on specific recommendations regarding the examination of dealer banks, rulemaking authority over sales practices or other proposed amendments to the Act.

I welcome the opportunity to comment and hope that you will not hesitate to call on Fannie Mae to provide detailed information as appropriate on the markets in which we participate.

Sincerely,

GLP/wle

cc: The Honorable John Heinz
David O. Maxwell

11 Wall Street
New York, NY 10005
212 656 5150

Richard A. Grasso
Executive Vice Chairman

NYSE
New York
Stock Exchange, Inc

January 18, 1991

The Honorable Christopher J. Dodd
Chairman
Securities Subcommittee
534 Dirksen Senate Office Building
Washington D.C., 20510

The Honorable John Heinz
Ranking Minority Member
Securities Subcommittee
548 Dirksen Senate Office Building
Washington D.C., 20510

Dear Chairman Dodd and Senator Heinz:

The New York Stock Exchange (the "Exchange") is pleased to respond to your letter of December 10, 1990 addressed to former Chairman John Phelan and to participate in the consideration of supplemental legislation to the Government Securities Act of 1986 (the "GSA" or the "Act"). In this connection, the Exchange has reviewed the join Treasury/SEC/FRB (the "Agencies") "Study of the Effectiveness of the Implementation of the Government Securities Act of 1986" and the previous GAO Report entitled: "More Transaction Information and Investor Protection Measures Are Needed".

By way of brief background, generally speaking the Constitution and Rules of the Exchange apply uniformly, to every member and member organization of the Exchange - regardless of its business lines or customer mix. As such, the Constitution and Rules do not recognize separate categories or classes of members - such as those who might engage exclusively in government securities. Consequently, the financial, operational, and sales practice rules of the Exchange, as well as the annual examination of its members and member organizations are respectively applied and conducted in a consistent and cohesive manner. It is perhaps for this reason that the Exchange has not experienced the difficulties and disparities reported in the cited studies nor has it perceived any specific difficulties uniquely attributable to a government securities business. It is the belief of the Exchange that its body of regulations works well and is not in present need of being supplemented, within the context of your inquiry.

The Exchange applauds the work of the Treasury in implementing the GSA and believes that the success of this effort, in no small measure, is due to the cooperation of and the degree of consultation had with the SEC, the Federal Reserve Board and others, and the deference given to pre-existing regulations and the principles underlying them. Subject to these mechanisms for consultation and cooperation, the Exchange favors the extension of the rulemaking authority vested in the Treasury for these reasons and because of its unique sensitivity to the government securities market, in order to continue fine-tuning measures in the areas already encompassed by the Act. Based upon the joint recommendation of the agencies, it would appear appropriate to legislate the changes noted in the joint agency Study to effect a reallocation of the appropriate regulatory agencies.

The studies cited above enumerate three additional areas not presently comprehended within the existing grant of rule-making authority to the Treasury - each of which is addressed in the following comments: The Exchange would support removal of present inhibitions upon the NASD in the application of pre-existing sales practice rules (e.g. unreasonable mark-ups, churning, suitability) to registered government securities brokers/dealers and, to the extent necessary, the grant of explicit authority to bank regulators to review the government securities sales practices of bank dealers. The Exchange does not perceive a need for the creation of new rules in this area given the rules, norms and standards presently in effect.

While we would agree in principle to mandatory SIPC membership for entities exclusively engaged in the government securities markets, thereby extending SIPC coverage for customer accounts of such entities, we would defer to SIPC in this regard and to the satisfaction of its expressed concerns. Customers of full-spectrum broker/dealers, who constitute the membership of the Exchange, presently are protected by SIPC.

The Exchange expresses no view at this time in regard to expanded access to transaction information from interdealer systems.

We are not aware of any demonstrated need for additional specific curative legislation at this time.

The Exchange would be most pleased to work with the Subcommittee and its staff at this legislation develops.

Respectfully,

Richard A. Grasso
Executive Vice Chairman

GOVERNMENT FINANCE
OFFICERS ASSOCIATION

1750 K Street, N.W., Suite 200, Washington, D.C. 20006
202/429-2750 • Fax: 202/429-2755

March 7, 1991

Honorable Christopher J. Dodd, Chairman
Honorable John Heinz, Ranking Minority Member
Subcommittee on Securities
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C.   20510-6075

Dear Senators Dodd and Heinz:

The Government Finance Officers Association (GFOA) appreciates the opportunity to present its position on issues related to the reauthorization of the Government Securities Act of 1986 (GSA) and to comment on the two reports issued last fall assessing the Act -- the General Accounting Office (GAO) report entitled U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed and the joint study by the Department of the Treasury, the Federal Reserve Board of Governors, and the Securities and Exchange Commission (SEC) entitled Study of the Effectiveness of the Implementation of the Government Securities Act of 1986.

GFOA is a professional association of over 12,000 state and local government officials, both elected and appointed, whose responsibilities include all the disciplines related to public finance. On February 26, 1991, the GFOA Executive Board approved a policy statement regarding the reauthorization of the GSA. A copy of this policy statement is enclosed.

GFOA has long advised our members to exercise caution in the investment of public funds. It has recommended that investors obtain competitive bids and proposals, and that they secure acknowledgement from their depositories and dealers of written copies of their investment policies, risk constraints, and trading requirements. Governmental investors are also advised to be aware of reasonably foreseeable risks of market price loss, illiquidity, nonmarketability, or default of investment instruments prior to purchase.

HEADQUARTERS OFFICE
180 North Michigan Avenue, Suite 800, Chicago, Illinois 60601
312/977-9700 • Fax: 312/977-4806

However, GFOA has also consistently supported federal legislation to facilitate self-regulation and surveillance of sales practices of all securities dealers who conduct transactions involving U.S. government securities and money market instruments.

While GFOA is concerned generally with investor protection, the GFOA policy regarding the GSA reauthorization addresses only sales practice rules specifically. These would include standards of practice, securities selection suitability, and price markups. The policy does not address the issues of access to pricing information or extension of Securities Investor Protection Corporation (SIPC) coverage, although we agree with both reports that these are issues worthy of further consideration.

Need for Sales Practice Rules

In 1989, according to the GAO report, Treasury raised $1.2 trillion by the sale of its securities. Outstanding marketable debt that year was $3.3 trillion. The types of instruments traded range from "plain vanilla" Treasury obligations to derivative instruments of uncertain characterization and risk. While investment in some of these instruments is relatively risk-free and easily understood, investment in others may involve a great deal of risk and may be appropriate for only the most sophisticated investors.

Why is investor protection so crucial to state and local investors? A look at the typical local government makes it clear. In addition to the 50 states, the 1987 Census of Governments figures state that there are 83,186 units of local governments. Of these, 38,933 are general-purpose local governments -- counties, municipalities, and townships -- while the remainder represent school districts and special districts. Only 5,722 of these general-purpose local governments have populations over 10,000.

Periodically, due especially to the timing of tax receipts, many of the 33,211 governments with populations under 10,000 have significant amounts of money to invest. Cash flow needs, though, dictate that funds be immediately available throughout the year. These small jurisdictions are unable to afford highly skilled investment experts to handle their funds. Investments are made by public servants who may be part-time employees, officials with numerous other responsibilities and no prior exposure to investments, or simply individuals unacquainted with government securities. In taking their fiduciary responsibilities seriously, they attempt to maximize their jurisdiction's investment earnings by investing in what they understand to be "safe" obligations, but with which they lack expertise. (Indeed, even professional practitioners in the securities field are often baffled by some of the federal products entering the market.) It is important that these governmental investors, entrusted with public funds, have confidence in the broker or dealer trading in government securities in order for them to make the most advantageous yet suitable investment for their jurisdiction. Ultimately, the burden of an unsuitable or overpriced investment falls on the state and local taxpayer.

The government securities market is the last fertile ground for unscrupulous or incompetent dealers, and there is evidence that they are taking advantage of this window of opportunity. The GAO report indicates that losses to state and local governments as a result of improper sales practices are increasing. GFOA has collected examples from around the nation which demonstrate abuses of markup, suitability, and churning. However, the promulgation of rules regulating their activities has severely limited the opportunities for sales practice abuses in municipal and corporate markets. Distinctions between sales of government securities and other securities are unwarranted. Certainly traders dealing in the same activities should be held to the same standards of practice. It is clearly time that the GSA be amended to provide for sales practice rules for all U.S. government securities brokers and dealers.

Rulemaking Authority

Unlike the GAO and Joint Agency studies, GFOA does not endorse a particular entity as rulemaker. It appreciates the fact that the reports find that Treasury has provided balanced regulatory treatment and has been effective in promulgating rules for which it currently has jurisdiction under the GSA.

However, GFOA members have raised concerns about the appearance of a potential or actual conflict of interest if Treasury is granted rulemaking authority over transactions in its own obligations, and they fear that the grant of such authority may undermine the integrity of the market. GFOA recognizes that other agencies and entities have expertise in regulation and enforcement for other securities and suggests that these alternatives be considered when this determination is made.

Rules Should Be Similar to Those in Other Markets

As discussed earlier, corporate and municipal markets are already governed by sales practice rules. The Securities and Exchange Act of 1934 required that all exchanges and corporate securities associations promulgate rules for their members to supplement that legislation and accompanying regulations. Rules developed by self-regulatory organizations such as the National Association of Securities Dealers, Inc. (NASD) have often substituted for SEC regulations. Similarly, sales practice rules modeled on the NASD rules apply to municipal securities trading. The Municipal Securities Rulemaking Board (MSRB), another self-regulatory organization, has developed these rules.

As noted previously, no justification exists for distinction between markets regarding sales practices. At one time, the opportunities for abuse in corporate and municipal markets mirrored those which are now available in the government securities market. These are the opportunities which ought to be eliminated.

There is no evidence that the corporate or municipal securities sales practice rules have overly burdened either market. Any additional costs incurred have not substantially impeded the sales of these obligations. In a market the size of the federal securities market, the costs would be so widely distributed that any effects should be minimal. In addition, the vast majority of broker/dealers trading in government securities are already complying with similar rules and procedures in their trading of other securities. Any burden placed on them as a result of new sales practice rules would not significantly increase their existing administrative responsibilities.

Enforcement Authority

GFOA supports granting authority for enforcement of sales practice rules to bank and non-bank regulators. Some broker/dealer activities in government securities are already subject to enforcement through their exchanges or bank regulators, but many dealers remain unregulated. This results in uneven protection for the investor and unfair competition among dealers.

For those agencies currently handling enforcement matters, the knowledge and resources to handle such enforcement already exist. In addition, restrictions on NASD should be lifted to allow it to enforce sales practice rules for its own members. NASD is familiar with the markets and sales practice standards. It has the resources for educating its members and would be able to require dealer qualifying exams. Removing this prohibition would permit disciplinary action in cases where there is no evidence of fraudulent intent. Both GAO and the Joint Agencies state that NASD has been successful in meetings its compliance examination goals.

GFOA also endorses a meaningful role for the SEC. The SEC is already responsible for dealer registration and has regulatory and enforcement authority for newly registered broker/dealers under the Act. It has expertise in both rulemaking and enforcement, and may be perceived as an impartial party in the regulation of Treasury securities.

Sunset Provision

GFOA, for the reasons outlined in the GAO report, supports the inclusion of a sunset provision in new legislation authorizing sales practice rules. This will give Congress an opportunity to review the rulemaking process and the specific sales practice rules promulgated by the rulemaking authority. There will be an opportunity to assess the ability of the regulator to monitor compliance, and to identify either gaps in coverage or excessive or burdensome regulation.

Legislative Language

For the reasons stated, GFOA suggests that legislative language give clear authority to a particular entity to write objective and workable sales practice rules which protect the investment of public funds without impeding the functioning of the government securities market. We oppose any attempt to dilute sales practice rules as they apply to governmental investors based on the size of investment portfolios.

GFOA looks forward to working with you on the reauthorization of the Government Securities Act. If we may provide additional information, please do not hesitate to contact Betsy Dotson at the GFOA Federal Liaison Center at 202/429-2750.

Sincerely,

Catherine L. Spain

Catherine L. Spain
Director, GFOA Federal Liaison Center

Enclosure

GOVERNMENT FINANCE OFFICERS ASSOCIATION

Policy Statement

Reauthorization of the Government Securities Act

In order to achieve adequate investor protection in the government securities market, the Government Finance Officers Association (GFOA) supports federal legislation amending the Government Securities Act (GSA) to include sales practice rules for government securities dealers. The Association supports the adoption of sales practice rules that are appropriately similar to those in other regulated securities markets. The GFOA further recommends the granting of explicit enforcement authority to bank and non-bank regulators including self-regulatory organizations (SROs) and a meaningful role for the Securities and Exchange Commission. A sunset provision should be included in the Government Securities Act to provide an opportunity to review the rules and the regulatory structure.

Approved by: GFOA Executive Board
February 26, 1991

Public Securities Association
40 Broad Street
New York, NY 10004-2373
(212) 809-7000 or (212) 440-9400
Telecopier: (212) 797-3895 or
(212) 742-1549

PSA

January 22, 1991

The Honorable Christopher J. Dodd
Chairman
Securities Subcommittee
Committee on Banking, Housing
and Urban Affairs
534 Senate Dirksen Office Building
Washington, DC 20510-6075

The Honorable John Heinz
Ranking Minority Member
Securities Subcommittee
Committee on Banking, Housing
and Urban Affairs
534 Senate Dirksen Office Building
Washington, DC 20510-6075

Dear Senator Dodd and Senator Heinz:

The Public Securities Association ("PSA")1/ greatly appreciates the opportunity to provide its views on the recommendations and proposals set forth in U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed (the "GAO Report") and Study of the Effectiveness of the Implementation of the Government Securities Act of 1986 (the "Joint Report"), as well as other issues related to reauthorization of the Government Securities Act of 1986 (the "GSA"). In general, PSA believes that the GSA is exemplary securities legislation, which has achieved the dual goal of improved investor safety without adversely affecting the government securities market's liquidity and efficiency. Our views on specific issues are set forth below.

1/ PSA is an international trade association representing approximately 300 banks, dealers and brokers that underwrite, trade and distribute U.S. government securities, mortgage-backed securities and municipal securities. All of the primary dealers, as recognized by the Federal Reserve Bank of New York, are PSA members.

Reauthorization of the Treasury

PSA supports the recommendation in the Joint Report and the GAO Report that Congress extend Treasury's rulemaking authority.

In selecting Treasury as the rulemaker under the GSA, Congress concluded that Treasury's market expertise and responsibility for managing the public debt would ensure that the GSA did not inadvertently damage a market that is so vital to the government's ability to finance the federal deficit. The past four years have validated Congress' conclusions. The market believes that the GSA has improved investor safety without imposing overly burdensome regulatory requirements. In PSA's view, the GSA regulations reflect effective, on-going consultation and coordination with not only the other Federal regulators, enforcement bodies and self-regulatory organizations, but with the industry as well.

We also believe that the GSA rules have been fairly implemented. The government securities market encompasses financial institutions, diversified broker-dealers and specialist broker-dealers, each of which is subject to a different regulatory scheme. Therefore, in addition to protecting investors, a single regulator must avoid competitively disadvantaging any category of broker-dealers. PSA believes that the GSA regulations provide a reasonably level playing field for all market participants.

Finally, while Treasury is expected to be knowledgeable of and sensitive to costs affecting Treasury securities, it has demonstrated these same characteristics toward the agency and agency mortgage-backed securities markets, which it also regulates. PSA concludes that the Treasury's development and application of its rules has been fairly and uniformly applied to each of these markets.

Accordingly, PSA believes that Treasury's rulemaking authority should be extended. Treasury's market knowledge and cost sensitivity, which were the bases for Congress' initial decision to empower Treasury, warrant the continuation of its regulatory authority. In reaching this conclusion, we assume that any additional rules would continue to be enforced by each broker-dealer's "appropriate regulatory agency" as they currently are, i.e., by the SEC, self-regulatory organizations and the bank regulators.

Government Securities Pricing Information

PSA supports expanded access to government securities pricing information. Throughout 1990, PSA has been developing an industry joint venture, known as "GOVPX Inc.," that will begin disseminating pricing information in March, 1991. The joint venture will provide 24-hour, global, real-time information on U.S. Treasury securities to anyone wishing to purchase the information. We believe that this joint venture obviates the need for legislation.

In December 1987, the GAO issued a report to Congress, required by the GSA, on access to brokers' services.2/ In that report, the GAO concluded that access to information on transactions executed among primary dealers through interdealer brokers should be expanded. The GAO stated that private sector initiatives would be the most efficient method of achieving this goal. Therefore, market participants should be given time to voluntarily expand access on their own. The GAO recommended that federal regulation should be considered only if private sector initiatives failed.

PSA has been working on this issue since passage of the GSA. In November 1988, PSA's Primary Dealers Committee, which represents all primary dealers and interdealer brokers, established a task force to consider expanded access to price information. The task force issued a report in April 1989, which supported broader dissemination of price information, cited several private sectors initiatives that were then underway and, consistent with the 1987 GAO Report, concluded that the market should be permitted to select among these competing initiatives. The Primary Dealers Committee unanimously endorsed this report.

Six months later, none of the initiatives had succeeded in expanding access to price information. Therefore, in November 1989, the Primary Dealers Committee established another task force to develop proposals for a PSA-sponsored joint venture to disseminate price information. These proposals were presented to and approved by the Primary Dealers Committee in April 1990. Since then, PSA, through a steering committee representing seven primary dealers and two interdealer brokers, has worked on establishing a joint venture of primary dealers and interdealer brokers to disseminate price information.

The steering committee comprises representatives of: Daiwa Securities America Inc.; Garban Ltd; Goldman, Sachs & Co.; Liberty Brokerage Inc.; J.P. Morgan Securities Inc.; Morgan Stanley & Co. Incorporated; Prudential-Bache Securities Inc.; Salomon Brothers Inc, and S.G. Warburg & Co. Inc. Under its auspices, the joint venture has conducted a market demand survey by retaining the services of McKinsey & Co., begun preliminary vendor negotiations with firms such as Reuters and Telerate, and raised working capital from all of the participating brokers and dealers. The joint venture was incorporated in Delaware on December 21, 1990. Legal documents, capitalization, regulatory approval and technical testing are currently being finalized.

2/ U.S. Government Securities: An Examination of Views Expressed About Access to Broker's Services (December 1987).

In its initial phase, the joint venture will disseminate information on all U.S. Treasury bills, notes and bonds. Information will include executed trade prices and volumes, quotation information, yields and daily aggregate volumes in each security. The hardware and software systems for consolidating and disseminating the information have been developed and will be maintained by ADP Financial Information Services, Inc. All of the primary dealers are expected to be shareholders of and disseminate price information through the joint venture.

The joint venture was formed to address comprehensively the public policy mandate for expanded access to government securities price information. As a private sector initiative, it represents the GAO's preferred method of achieving this goal and should obviate the need for legislation.

Sales Practice Authority

PSA supports the principal of applying fair sales practice rules to the government securities market. Notwithstanding this position, we agree with the Joint Report conclusion that abusive sales practice problems have not been widespread and that several recent well-publicized losses are not necessarily attributable to such abuses.3/ We also note that the GAO, in preparing its report, did not independently assess the prevalence of sales practice abuses in the government securities market.4/ PSA believes that the GSA's success in balancing investor protection and market efficiency was based on Congress' decision to limit the Act's scope to areas of documented abuse and weakness in the government securities market. We strongly urge Congress to adopt a similar approach in enacting any additional legislation of this market.

3/ Joint Report at 81.

4/ GAO Report at 48. However, we take strong exception to the GAO's conclusion that sales practice rules are beneficial "because they can be used by customers as support for legal action...alleging wrongdoing by brokers and dealers." Rules of self-regulatory organizations have traditionally not created private causes of action. More importantly, adopting rules with the goal of establishing liability, rather than responsibility, will impose on the industry precisely those costs that Congress sought to avoid.

PSA would not oppose reasonable rules of fair practice that, for example, prohibit excessive mark-ups and churning and promote suitability of investments, provided that the rules are tailored to the government securities market and the variety of securities it encompasses. For example, we would expect that standards governing excessive mark-ups for actively-traded Treasury securities would differ significantly from those governing less liquid mortgage-backed derivative instruments. As evidence of the industry's willingness to be proactive in ensuring investor confidence and market integrity, PSA has established a broad-based committee to consider these issues and develop proposals for sales practice rules.

Although the committee is currently considering technical issues, it has identified general principles that should govern any sales practice rules. Rules must be flexible enough to ensure that controlling any abuses does not unintentionally damage the market. In this regard, we support the GAO's observation that "sophisticated" investors should be excluded from coverage based on their knowledge of risks, values and prices.5/ Any definition of "sophisticated" investor must, at a minimum, include institutional investors and must hold such investors to a high degree of competence and accountability for their investment decisions. Changes in the market, such as broader dissemination of price information, will increase investors' sophistication based on improved access to market information.

In addition, PSA strongly urges Congress to ensure that any rules fairly allocate responsibility between broker-dealers and investors. Protecting investors, particularly sophisticated ones, by transforming broker-dealers into insurers against all loss would severely disrupt the market. We are also concerned that confusion exists over the scope of current sales practice rules. To the extent that concerns of abusive practices relate to privately-issued mortgage-backed securities (which include mortgage-backed securities collateralized by agency securities if they are issued by a private entity), these securities are already subject to NASD rules of fair practice. Finally, to avoid competitively disadvantaging any sector of the market, any sales practice rules should be applied uniformly to all market participants.

5/ Id. at 59.

In sum, we believe that any sales practice rules should be based on specifically identified problems, e.g., do abusive practices, if any, fall into specific areas or are they more general in nature, do they apply to only certain types of securities and/or investors. Failure to examine these issues will greatly increase the likelihood of adopting unwarranted and overly burdensome regulation which will increase the cost of governmental financing. PSA would be delighted to assist legislative staff in identifying any areas of concern and developing appropriate resolutions.

Expansion of SIPC Insurance

PSA has not yet adopted a position on whether to expand SIPC insurance to the customer accounts of specialist government securities brokers and dealers. While our committee considers its position, we note several points. If SIPC coverage were extended to these firms, SIPC's members would include, for the first time, firms that are not registered under Section 15(b) of the Exchange Act of 1934 and which are, therefore, not subject to the SEC's full rulemaking authority. Congress should consider how this lack of uniform regulation, particularly financial responsibility rules, would affect SIPC. In addition, SIPC insurance is not available to customers of financial institution government securities brokers and dealers. Congress should also consider how SIPC insurance affects the GSA's goal of uniform regulation. Most importantly, Congress should consider what costs would be associated with extended insurance coverage and whether increased investor protection would outweigh the costs.

In addressing this issue, Congress may wish to consider whether concerns regarding investor confusion could be adequately and more cost-effectively addressed through disclosure. For example, under the GSA regulations, all broker-dealers were required to include disclosure in repurchase agreements that federal insurance, whether SIPC, FDIC, FSLIC or NCUIF, as applicable, would not cover repurchase transactions.

Incidence of Noncompliance/Frequency of Examinations

In considering the degree of compliance with the GSA by government securities brokers and dealers, the GAO noted that the Joint Report, which would address the effectiveness of GSA rules, would be an appropriate place to discuss recommendations in this area.6/ The Joint Report separately reviewed each regulator and category of government securities dealer.

6/ GAO Report at 41.

The NASD reported that implementation by specialist government securities dealers was "excellent."7 Similarly, the NYSE concluded that the level of compliance for firms it regulates is "good."8/ The Joint Report found that the OCC's compliance examinations of national banks have been very thorough and that violations were precipitated principally by uncertainty regarding the regulations. The OCC has, in each case, obtained commitments to correct the violations.9/ Regarding state bank members of the Federal Reserve System, the Board reported that the general level of compliance has been good and that violations found during examinations were minor and easily correctable.10/ The Joint Report expressed concern that the FDIC was not disseminating regulatory information with sufficient frequency. However, it noted that the FDIC had recently developed plans for correcting this deficiency.11/ Finally, the Joint Report notes that only one savings association had registered as a government securities dealer and it has since withdrawn from the business.12/

Based on this report, PSA believes that regulatory noncompliance, to the limited extent that it exists, is largely technical and based on firms' gaining familiarity with a new regulatory system. Therefore, we do not think additional action in this area is warranted. However, we believe that regulatory effectiveness depends on appropriate enforcement. Therefore, we strongly support regular examinations of all entities conducting government securities business. However, as the GAO Report acknowledges, other issues affecting the banking industry have strained bank examination resources. Accordingly, we believe that any action in this area should have due regard for this situation and reflect reasonable priorities among competing public policy considerations.

7/ Joint Report at 61.
8/ Id. at 62.
9/ Id. at 64.
10/ Id. at 66.
11/ Id. at 68.
12/ Id. at 69.

* * * *

PSA greatly appreciates this opportunity to provide its views to the Securities Subcommittee. If we can provide you with any additional information, please do not hestitate to contact Frances Bermanzohn, Senior Vice President and General Counsel (212-440-9412) or Betsy Barclay, Director of Legislative Affairs (202-898-9390) of the PSA staff. We have already begun to work with your staffs on this issue and we look forward to working with them throughout the reauthorization process.

Sincerely,

Ralph Horn /BB

Ralph Horn
Chairman, PSA Board
of Directors

1970L

AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C.
20036

AGENCY RELATIONS,
TRUST AND SECURITIES

DIRECTOR
James D. McLaughlin
202/663-5324

January 25, 1991

The Honorable Christopher J. Dodd
Chairman
Securities Subcommittee
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, DC 20510-6075

The Honorable John Heinz
Ranking Minority Member
Securities Subcommittee
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, DC 20510-6075

Dear Senators Dodd and Heinz:

The American Bankers Association appreciates the opportunity to offer its views on recommendations for legislation made by the Department of the Treasury ("Treasury"), the Board of Governors of the Federal Reserve System ("FRB") and the Securities and Exchange Commission ("SEC") in its Study of the Effectiveness of the Implementation of the Government Securities Act of 1986 and by the General Accounting Office ("GAO") in its report entitled U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed. The ABA represents banks of all sizes and types, and in all locations. Assets of our membership represent approximately 95% of the industry total. As such, the issues raised by these reports are of vital concern to our members.

Many of our members play an active role in the government securities market greatly adding to its depth and liquidity. Our members operate as both specialized and diversified primary dealers, as well as non-primary dealers. In the distribution channel for government securities, these non-primary dealer banks typically stand between the primary dealers and the ultimate investors, specializing in transactions that are smaller than those typically handled by primary dealers. Government securities activities of these members may be conducted in either a separate securities affiliate regulated by the SEC and the National Association of Securities Dealers ("NASD") or the New York Stock Exchange ("NYSE") or a bank dealer department regulated by the bank's primary regulator. In addition, our members serve as brokers, clearing banks, and investors. They purchase and sell government securities for their own investment portfolios and dealer accounts as well as for trust, custodian and other customer accounts. As investors, our members contribute to the fact that the government securities market is the largest securities market in the world -- a market that plays a critical role in implementing our nation's monetary and fiscal policy.

As the cornerstone of the U.S. capital market system, public confidence in the government securities market is essential. The failure of several unregulated government securities dealers in the early 1980s and the accompanying destabilizing effects upon financial markets caused by these failures caused the Congress to enact the Government Securities Act of 1986 ("GSA"). That Act created a limited regulatory structure that addressed the areas in need of reform: registration, recordkeeping, capital adequacy, financial reporting and audit, and custody of securities used in certain financing transactions. Authority to promulgate implementing regulations was given to the Treasury Department.

The ABA believes the GSA and Treasury's implementing regulations generally have accomplished the goals of maintaining the integrity of the government securities market, preserving liquidity and efficiency of that market, and satisfying investor protection needs. The ABA has consistently gone on record in supporting Treasury's efforts to draft regulations that insured investor protection and continued efficient operation of the market. The ABA has, however, opposed regulation that would unduly burden market participants and restrict the government securities market. It is with those guiding parameters that the ABA offers its views with regard to the various recommendations for legislation.

Investor Protection

Sales Practice Rules

The GAO has recommended that Congress amend Section 15 of the Securities Exchange Act of 1934, 15 U.S.C. 78o, to permit the adoption of general rules of fair practice applicable to all government securities brokers and dealers. Sales practice rules are intended to ensure fair dealing among market participants and to protect investors. These rules generally cover pricing practices, suitability requirements, and prohibitions against excessive trading of customer accounts to generate commissions. The GAO has recommended that, at a minimum, sales practice rules should be promulgated, covering pricing practices (price mark-up rules) and investor suitability requirements.

The FRB, Treasury and the SEC were unable to reach a consensus on either the need for, or scope of, any additional regulatory authority to address sales practices. Quite correctly, their joint report notes that the GSA was never intended to set sales practice rules for the government securities market but rather was enacted to correct specific identified weaknesses in that market, including the registration and regulation of previously unregulated government securities brokers and dealers and regulation of repurchase transactions.

Moreover, in making its initial determination not to provide authority for promulgating sales practice rules, Congress was concerned about the potential costs of sales practice rules and possible effect those rules could have on the government securities market. The ABA believes that those same concerns are valid today.

Consequently, before Congress determines whether or not general sales practice rule authority should be enacted, an analysis of the costs associated in complying with sales practice rules and the benefits to be gained must be undertaken. Specifically, any such rules must be carefully constructed in order to meet the need for investor protection without negatively impacting the marketplace by constructing impediments to the efficient flow of these securities.

While the ABA, in principle, is not opposed to the idea of incorporating sales practice rules into the government securities market, the ABA does question the need for any blanket grant of authority in this area. All government securities dealers are subject to antifraud and antimanipulative liability under the federal securities laws. Sections 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), and 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), prohibit material misstatements or omissions and fraudulent or manipulative acts and practices in the offer, purchase and sale of securities. The SEC is charged with enforcing those laws. Moreover, during the 101st Congress, that enforcement authority was strengthened when the Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Public Law No. 101-429. Under that Act, the SEC may now seek civil money penalties for violations of the federal securities laws. These penalties can result in liability of up to $100,000 for a natural person or $500,000 for a corporate entity.

Some of our members operating separate securities affiliates are examined by the NYSE. In the course of conducting their examinations, the NYSE examines the government securities sales practices of these firms to determine whether the firm is in compliance with NYSE sales practice rules. In addition, bank dealer departments operate in accordance with the rules of the SEC, NASD and MSRB, including those organizations' sales practice rules. While applicable sales practice rules do not on their face apply to government securities transactions, bank dealers have incorporated those sales practice rules into their government securities policies and procedures. Moreover, bank regulators examine these departments for compliance with those policies and procedures.

Consequently, rather than duplicate the compliance programs already in place and, by all accounts, operating successfully,[1] an alternative may be for the Congress to simply remove that prohibition in the GSA that prevents the NASD from applying sales practice rules to government securities transactions. By permitting the NASD to apply sales practice rules to firms over which it has regulatory authority, certain government securities brokers and dealers would no longer be exempt from their coverage. Consequently, all government securities brokers and dealers, no matter who their regulator, would be required to comply with sales practice rules, including price mark-up and suitability rules. Under such an approach, the majority of dealers that currently conform to the law and principles of fair dealing would not be burdened by requirements designed to prevent abuses by a few unscrupulous dealers.

Moreover, any sales practice rules adopted must differentiate between wholesale transactions involving large commercial banks, insurance companies, and major pension funds, and retail transactions. Wholesale investors are sophisticated and do not need the investor protections offered by sales practice rules. As the GAO report notes, "these large investors are more like competitors than customers because of their sophistication and the size of the positions traded." The ABA would concur with the GAO that sales practice rules designed to protect retail customers should not impair or inhibit participation in the wholesale market.

---

[1] Both the NYSE and the bank regulators, through their examinations, have successfully addressed improper sales practice of government securities dealers.

To protect retail customers, it may be appropriate for various industry groups to offer guidance to their members on the suitability of, and risk factors associated with various government securities. For example, the Federal Financial Institutions Examination Council ("FFIEC") has recently proposed revisions to its supervisory policies regarding the suitability of high risk mortgage-backed securities and zero-coupon bonds. This policy, if adopted by all member agencies, would apply to all depository institutions. Conceivably, similar guidance helpful to other retail participants in the government securities markets should be offered by their particular industry organization.

Advertising

In its report, the GAO has recommended that advertising rules comparable to those of the NASD rules be made applicable to bank dealers. Specifically, because the NASD requires all registered dealers to submit advertisements for review, the GAO has suggested that bank regulators adopt comparable regulatory programs for bank dealer advertisements.

While it is true that the bank regulators do not have comparable rules nor do they require bank examiners to specifically evaluate bank dealer advertisements, bank regulators, nevertheless, have the authority to investigate bank dealer advertisements under the federal securities laws antifraud rules. Moreover, as with sales practice rules, the ABA's position is that any specific regulation of advertising should be carefully crafted so as not to negatively impact the marketplace. Consequently, identification of specific abuses and not comparability of regulation should determine whether specific rules and regulations targeted toward bank dealer advertisements should be promulgated. Few dealers, bank and non-bank alike, advertise their government securities activities. In fact, fewer than 10 percent of all NASD-regulated government securities dealers submit advertisements for review. Moreover, no evidence has been offered to suggest that there are serious problems with bank dealer advertisements. In the absence of such proof, bank regulators should not be required to promulgate specific advertising regulation.

Hold-In-Custody Rules

The ABA believes that it is appropriate for the Congress to review the need and effectiveness of the hold-in-custody rules promulgated by Treasury as part of its regulations implementing the GSA. Those regulations require financial institutions that engage in hold-in-custody transactions to: obtain repurchase agreements in writing; make certain disclosures to the customer in the written repurchase agreement including the fact that funds held pursuant to a repurchase agreement are not insured; comply with certain possession and control requirements; and send confirmations of the specific securities that are the subject of hold-in-custody repurchase agreements at the end of the day on which the transaction was initiated and on any day on which there is a substitution of the securities.

While the ABA has consistently supported Treasury's efforts to draft regulations that assured investor protection, the ABA has opposed any regulation that would unduly burden market participants, restrict the government securities market and deprive certain investors of the benefits to be gained by using sweep transactions as investment vehicles. Consequently, the ABA, in April 1988, opposed that aspect of the hold-in-custody rules that required daily confirmations to be sent to customers. Our opposition was based largely on the administrative and operational costs associated with operating a sweep program.

As predicted, the administrative and operational costs are great while, at the same time, the daily confirmation requirement offers little in the way of real investor protection benefits to customers. Generally, banks hire outside service bureaus to process and forward daily confirmations to customers. The marginal cost of providing these daily confirmations is roughly $5.00 per confirmation. Assuming just one financial institution has 500 accounts in its sweep program, the yearly (assumes 240 work days) cost of providing daily confirmations for these accounts would be roughly $600,000. Multiply this figure by the number of banks operating sweep programs and the costs to the industry dramatically increase. In addition, other costs are incurred by banks in complying with the GSA such as employing individuals in-house to ensure such compliance. Postage alone is a significant cost and, as you are aware, will increase by 16% by next month. Moreover, customers continually question our members on the necessity of receiving these daily confirmations. To many of them, the receipt of daily confirmations is unnecessary and bothersome, particularly as many customers receive income on these sweep transactions on a daily basis. Consequently, notification embodied in the daily confirmation is received after the fact and offers little, if any, additional investor protection.

This is just one more example of the regulatory burdens borne by banks and their customers. While the investor protection purposes behind these regulations are important, a more efficient and less intrusive manner of accomplishing this important public policy goal must be achieved. In that light, the ABA continues to believe that the safekeeping exception originally adopted by Treasury adequately protects investors without creating enormous administrative and operational burdens and costs. That exception provided that a bank, among other things, did not have to send out confirmations to hold-in-custody repurchase customers if the securities were placed in the separate control of a safekeeping department of the bank and the bank did not retain the right to substitute the securities. Alternatively, the ABA would suggest that the Congress consider the options outlined below. The ABA believes that these options would, in a more efficient and less burdensome manner, amply protect investors.

The first and most preferable option would involve the concept of giving customers the option of declining to receive daily confirmations and, instead, require monthly account statements. Appropriate disclosures would, of course, be made. This concept of "opting out" is not novel, as many state takeover statutes provide corporations and their shareholders with the ability to decline the protections afforded by that statute. The monthly statements could detail every transaction and the amount of income earned on each transaction. The monthly statement would not merely summarize the status of the account at the end of the reporting month. In this way, customers will still receive much of the information currently required under Treasury rules. The major changes would be that the timing of receipt of that information would be delayed and the number of mailings would be decreased. Possibly additional protection could be provided to the customer by permitting them to obtain at any time a confirmation of the current repurchase agreement on the books.

Another option would permit financial institutions to surrender the right to substitute the securities collateral. It should be pointed out that this option is a variation on the Treasury's initial safekeeping rule. Moreover, this option would not necessarily be exclusive of the monthly account statement option outlined above. Financial institutions could offer their customers the choice of the option that best suits their particular business needs. Thus, under this option, a confirmation would be mailed out upon execution of the initial sweep transaction. So long as no new collateral were substituted, the initial confirmation would serve to notify customers of the specific collateral backing the transaction. From day to day, only the amount of collateral would change depending on the amount of funds swept and on the current market value of the collateral. Viewed in this manner, the transaction can be said to be one continuous repurchase agreement. Once new collateral was substituted, a new confirmation would, of course, be required to be delivered to the customer.

In light of the fact that market participants have had ample opportunity to experience first-hand the protection offered and the burdens associated with the hold-in-custody rules, the ABA believes it is now appropriate to re-examine both the continued need for daily confirmations and possible alternative approaches for ensuring that investor protection needs are met.

Expanded Access to Government Securities Pricing Information

The ABA is in full support of the principle that government securities transaction information should be made available to the marketplace. Historically, comprehensive transaction information has been restricted to customers of interdealer brokers. The ABA believes that by expanding access to government securities transaction information, market efficiencies will increase and investors will be better informed, thereby contributing to market liquidity. Moreover, it is believed that better price information could assist in the protection of investors, including the enforcement of price mark-up rules. Accordingly, the ABA supports the various private sector initiatives to allow market participants greater access to complete government securities market information.

One such initiative has been put forth by the Public Securities Association ("PSA"). PSA has announced that pricing information will be publicly available in the very near future. Vendors wishing to purchase this market information will have access to information on Treasury bills, notes, and bonds, including "last sale" price information, volume of executed trades, best bid and accompanying offer prices and yield information. It is the ABA's understanding that this information will be available on a 24-hour, global basis.

The ABA believes that the best means of achieving expanded access to price information is to allow these private sector initiatives to develop. Any concerns regarding delay in implementation of these private sector initiatives can be addressed by imposing a time limit for action. Failure to meet a federally-imposed time limit could then trigger authority for a federal agency to review the private-sector disclosure initiatives and develop standards, where necessary, for those initiatives.

Extension of SIPC Coverage

The Securities Investors Protection Act of 1970 does not extend insurance coverage to customers of brokers and dealers specializing in government securities. Diversified firms are, however, covered by insurance provided by the Securities Investor Protection Corporation ("SIPC"). In order to increase customer protection, GAO has recommended that SIPC insurance be extended to customer accounts of specialized government securities brokers and dealers.

Dealer banks are similarly not covered by SIPC insurance. As GAO notes, however, dealer banks are protected, to a certain extent, by FDIC insurance coverage. Specifically, cash received from a customer to buy securities would be considered an insured deposit (up to $100,000) if the bank were to fail while in possession of the customer's cash. Once the cash was converted into securities, the securities held for the customer would be returned to the customer should the bank fail.

The ABA believes that while this issue deserves some further exploration, resolution of this issue is not appropriate at this time. Questions and issues raised by the FRB, Treasury and the SEC, as well as SIPC, deserve full and complete analysis. Moreover, this issue may very well take on further significance should the Congress, in addressing deposit insurance reform, determine to limit FDIC insurance coverage for bank dealer customers.

In the meantime, the ABA would suggest that specialist firms fully and clearly disclose that customer funds and securities are not covered by SIPC insurance. Should a customer determine that insurance coverage is important, the customer will choose to do business with either a diversified non-bank dealer or a bank dealer. In this way, market forces and not regulation may achieve the effect, suggested by the GAO, of abolishing the specialist category of government securities firms.

Extension of Treasury's Rulemaking Authority

Treasury, the FRB and the SEC have jointly recommended that Congress extend Treasury's rulemaking and exemptive authority. The GAO has made a similar recommendation.

The ABA agrees that Treasury's rulemaking authority over the government securities market should be extended beyond October 1, 1991. Treasury is uniquely situated to balance the importance of maintaining an efficient and liquid government securities market with the need to meet investor protection concerns. Treasury has demonstrated its ability to effectively coordinate and consult with other government and self-regulatory entities. Indeed, that coordination continues more than four years after enactment of the GSA as Treasury and other agency representatives work toward developing a uniform capital standard applicable to all non-bank brokers and dealers.

Technical Changes to the Securities Exchange Act of 1934

Treasury, the FRB and the SEC have recommended that certain technical amendments be made to the Exchange Act. The effect of these amendments would be to transfer GSA enforcement responsibilities to that agency charged with general supervisory responsibilities. Specifically, the FRB would be designated as the appropriate regulatory agency for government securities activities of financial institutions that are Edge Act and Agreement Corporations, while the FDIC would be designated as the regulatory agency for insured state branches of foreign banks. The ABA concurs in these technical amendments.

Conclusion

The ABA appreciates the opportunity to offer its views on the GSA. If we can offer you any further assistance in this matter, please do not hesitate to call.

Sincerely,

James D. McLaughlin